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Spring 1989

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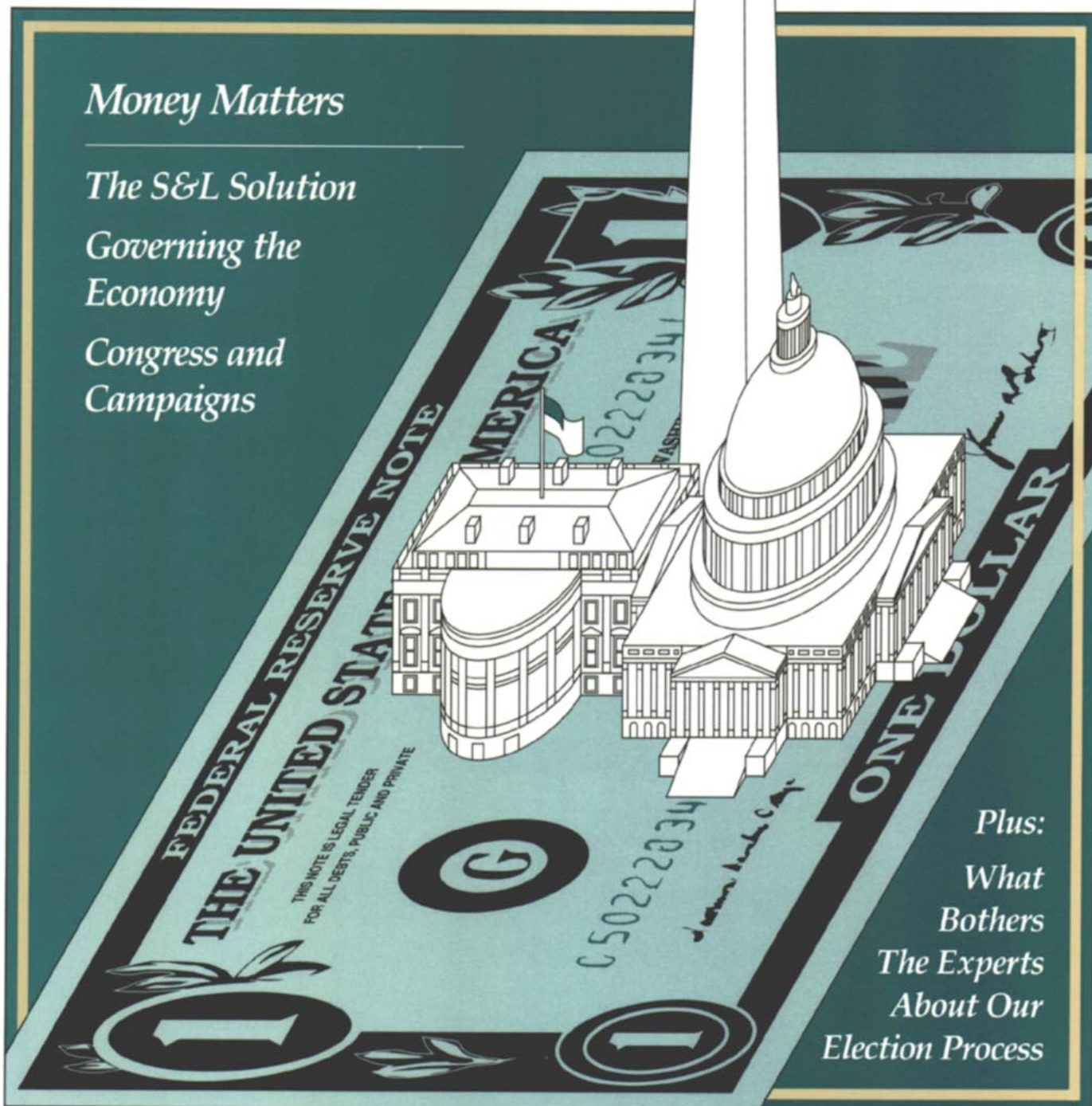
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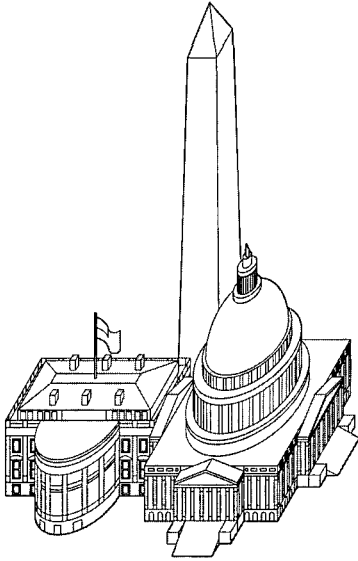
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The S & L Crisis: How to Get Out and Stay Out

R. Dan Brumbaugh Jr. and Robert E. Litan

At long last, public policymakers are acknowledging that the cleanup of the savings and loan industry can no longer be delayed. Faced with costs that may be growing by \$1 billion a month and that many experts believe will eventually exceed \$100 billion, President George Bush has made resolution of the thrift crisis an early priority.

In a crisis atmosphere, however, any rescue plan that attracts a consensus may be little more than a stopgap measure — one that stems the financial hemorrhage for a while but does little to minimize the cleanup costs or to correct the problems in the deposit insurance and regulatory systems that led to the crisis in the first place. In addition, publicity about the mounting thrift crisis has obscured a less severe but nonetheless substantial problem within the banking industry. The record profits reported for the industry as a whole in 1988 conceal the unrecognized costs of closing or merging many insolvent banks that are still operating, as well as the potential for many more bank insolvencies if the U.S. economy should dip into recession.

In this article, we offer our most recent estimates of the dimensions of the current crisis among America's depository institutions. We then explain how these crises arose,

dispelling several myths along the way. We conclude by offering suggestions both for resolving the immediate problems and for ensuring that they do not recur.

The Cost of Cleanup

Until the job is completed, no one can know for sure how much it will cost to clean up the insolvent thrifts. The Bush administration puts the figure at \$90 billion. Both the banking industry's insurer, the Federal Deposit Insurance Corporation (FDIC), and the General Accounting Office believe the final tab could be higher.

There are legitimate reasons for the different estimates. For one thing, the value of many of the assets held by insolvent thrifts cannot be determined with certainty. Cleanup costs also depend on the way that an insolvent thrift is removed from the system. The Federal Home Loan Bank Board and its insurance agency, the Federal Savings and Loan Insurance Corporation (FSLIC) usually have tried first to arrange a merger of the troubled thrift with a healthier partner by accepting bids from private parties. The party who puts up the most capital of its own and asks for the least assistance from the FSLIC wins the auction. If a merger cannot be arranged, the FSLIC can liquidate the thrift by paying off the depositors and assuming ownership of the assets.

The insurer can estimate which institutions will be merged in the future and which liquidated, but these guesses can be wrong. So too can the FSLIC's estimate of how much assistance it will eventually have to provide. All

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these uncertainties leave room for disagreement over the ultimate costs. Indeed, a relatively simple exercise helps to show why the cost estimation exercise is like shooting at a moving target.

At the end of 1988, 350 of the nation's 3,024 insured thrift institutions were insolvent under GAAP, or generally accepted accounting principles (*see figure 1*). These "GAAP-insolvent" thrifts collectively held approximately \$100 billion of the industry's \$1.3 trillion in assets. In 1986 and 1987 the FSLIC lost 32 cents on every dollar of assets held by institutions that were merged or liquidated. On that basis, it would eventually cost \$32 billion to remove the 350 GAAP-insolvent thrifts from the financial system. Through August 1988, however, the FSLIC's loss experience doubled to 65 cents on the dollar, which if duplicated in the future would push this cost up to \$65 billion.

But this estimated cost range is too low. It does not count more than 200 thrifts whose mergers the FSLIC assisted earlier in 1988 by extending to their new owners combinations of promissory notes and various guarantees. These guarantees obligate the FSLIC to pay an estimated \$38 billion in the future. Moreover, approximately 1,000 additional thrifts are weakly capitalized under GAAP standards; if their assets were measured on a market-value basis, a more realistic measure, many of them would be classified as insolvent. In short, the final cleanup tab could surpass \$100 billion.

By comparison, the FSLIC had cash reserves at the end of 1988 of only \$2 billion. If the current deposit insurance premium penalty imposed on thrifts is extended for another 10 years and if the FSLIC uses all of its current borrowing authority, it may be able to raise \$40 billion. But much of this revenue may be needed to pay the interest on bonds already issued by the FSLIC's financing affiliate, the Financing Corporation (FICO), as well as for future thrift failures. It thus will be unavailable to clean up the current mess. In short, the FSLIC is woefully short of the resources required to carry out its mission.

Unfortunately, the problems among America's depository institutions are not confined to thrifts. Figure 2 shows the significant growth throughout this decade in the numbers of failed and problem banks. We have estimated the strain unresolved bank failures will eventually impose upon the FDIC by calculating the capital positions of larger U.S. banks (those with assets above \$50 million) under the "risk-adjusted" capital guidelines recently adopted by U.S., Japanese, and European banking authorities. These guidelines require banks to have total capital — shareholders' equity, subordinated debt, and loan loss reserves — equal to 8 percent of their risk-adjusted assets (the standards establish various risk-weights for different assets; for example, cash has a zero risk weight, commercial loans are weighted at 100 percent). In our calculations, we exclude loan loss reserves because they will most likely be exhausted by future write-offs of bad loans.

The results shown in table 1 depict a sharp increase in the number of troubled banks in the 21 months between December 1986 and September 1988. By the end of the first

quarter of 1988, 28 banks with assets of \$23 billion were insolvent. Another 48 banks with assets of \$43 billion had capital-to-asset ratios between zero and 3 percent.

Like the FSLIC, the FDIC has had widely different loss ratios in removing problem banks from the system — ranging from as little as 10 cents on each dollar of assets in 1985 to as much as 75 cents on the dollar in 1982. The loss ratios tend to be greater for small banks than for large banks. If the cost of liquidating or merging the 28 insolvent banks represented in table 1 falls between 15 cents and 30 cents on the dollar (the ratio for 1987), the cleanup will run between \$3.5 billion and \$7 billion.

The cost could well be higher because our sample excludes the smallest banks. In addition, some, perhaps many, of the weakly capitalized banks under the GAAP-based, risk-adjusted standards are likely to be insolvent on a market-value basis, which could easily add another \$5 billion to the cost. As a result, the FDIC's actual reserve — net of future liabilities for merging or liquidating currently insolvent banks — is probably less than half the \$15 billion it had at the end of 1988.

What Has Gone Wrong?

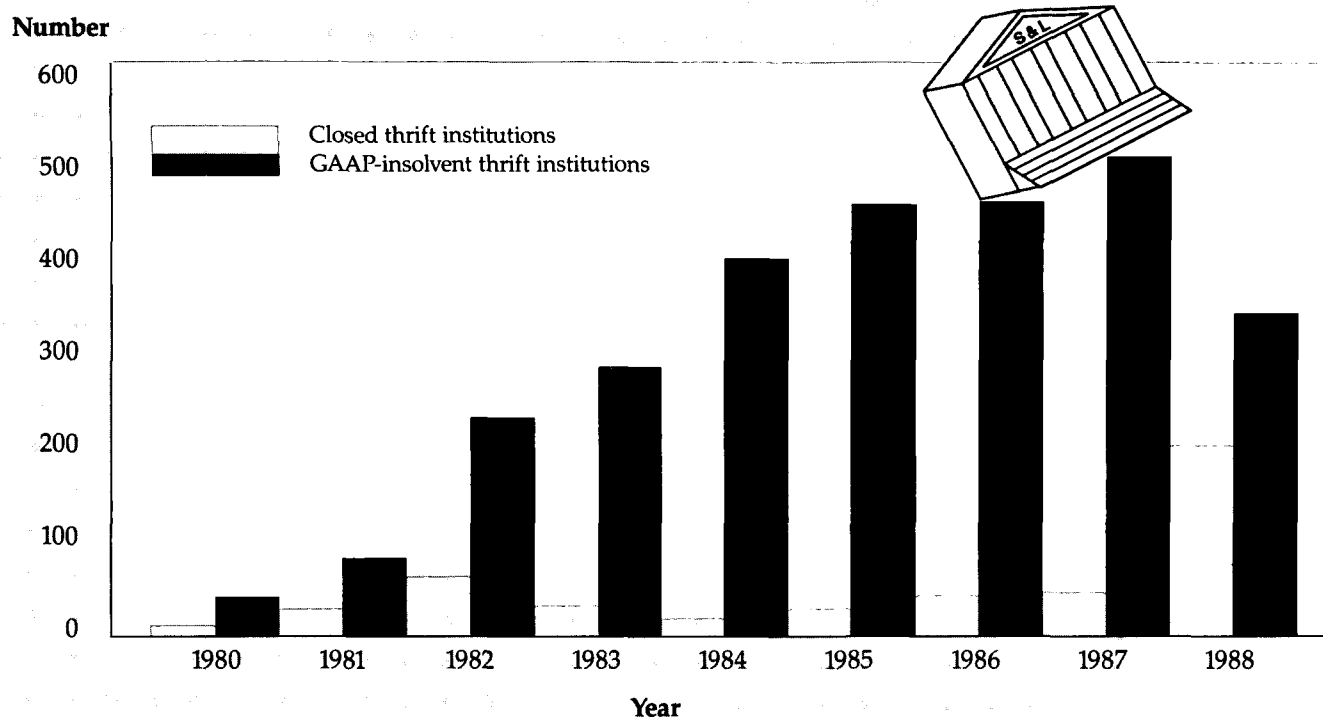
Despite the longest peacetime economic expansion in the nation's history, bank and thrift insolvencies climbed to post-Depression highs during the 1980s. Why has this happened?

To a significant extent, government restrictions on depository institutions have compounded serious economic shocks. U.S. law, for example, locked thrifts into investing primarily in long-term, fixed-rate residential mortgages. When short-term interest rates soared above long-term rates in the early 1980s, that restriction nearly killed the industry, which had to pay more for the deposits it collected than it earned on the loans it had made. Until short-term interest rates fell substantially in 1983, most thrifts were insolvent on a market-value basis. Moreover, until recently, most states in the Midwest and Southwest severely limited the ability of banks to branch and thus to diversify their deposits and loans. As a result, when agricultural and energy prices plummeted and local businesses failed, many banks went down with them.

The impression is nevertheless widespread that the current crisis stems largely from deregulation. In the early 1980s, for example, Congress removed Regulation Q, which had limited the interest rates banks and thrifts could pay their deposit customers. Congress also permitted thrifts to diversify their portfolios by making consumer and commercial loans. Certain states allowed the thrifts they charter even broader powers. All these actions, some argue, permitted aggressive institutions to pay whatever was necessary to attract deposits and then to reinvest those deposits in high-risk assets, many of which later turned sour.

Criticism of interest rate deregulation is clearly misplaced. Before the ceilings were lifted, bank and thrift depositors were rapidly transferring funds from their

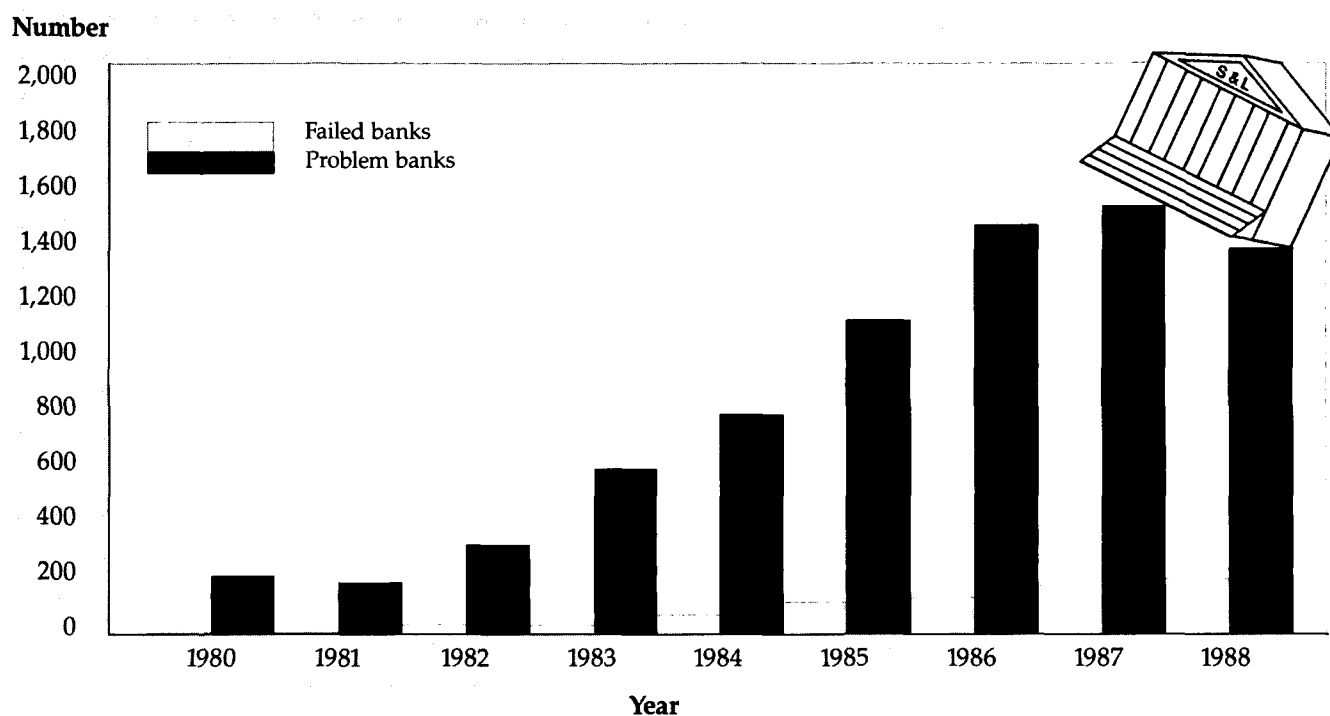
Figure 1. Thrift Insolvencies and Closures, 1980–88



Note: Insolvency is measured by generally accepted accounting principles. Closures include mergers.

Source: James R. Barth and Michael G. Bradley, "Thrift Deregulation and Federal Deposit Insurance," Federal Home Loan Bank Board Working Paper #150 (1988) and unpublished data from the FHLBB.

Figure 2. Failed and Problem Banks, 1980–88



Source: Federal Deposit Insurance Corporation 1987 Annual Report, Table 122, and unpublished data from the FDIC.

Table 1. Bank Capital Positions
(assets in billions of dollars)

Ratio of capital to risk-adjusted assets*	December 1986		March 1988	
	Banks	Assets	Banks	Assets
Less than 0%	2	\$ 2.0	28	\$ 22.5
0%–3%	20	8.9	48	43.4
3%–6%	93	886.6	150	926.0
More than 6%	5,262	1,772.7	5,094	1,894.5
Total	5,377	\$2,670.2	5,320	\$2,886.4

*Risk-adjusted capital is defined according to new capital guidelines. The figures in the table include all banks with at least \$50 million in assets.

Source: Drexel Burnham Lambert MBS Institutional Data Base.

Table 2. Balance Sheet for the Thrift Industry
(percentage distribution)

Category	Solvent Thrifts		Insolvent Thrifts	
	1982	1987	1982	1987
Assets				
Cash and securities	11.3%	13.3%	10.5%	11.5%
Mortgage assets	77.9	72.2	73.3	63.4
Residential	—	46.3	—	31.3
Commercial	—	9.9	—	14.5
Mortgage-backed securities	8.0	15.3	13.2	16.4
Other	0.6	0.7	0.7	1.2
Consumer loans	2.7	4.4	2.9	3.8
Commercial loans (nonmortgage)	0	1.7	0	1.9
Direct investments	1.2	2.2	1.2	4.4
Junk bonds	—	1.1	—	0.2
Reposessed assets	0.4	0.9	0.5	7.8
Other	6.5	4.2	11.6	18.5
Total	100.0	100.0	100.0	100.0
Liabilities				
Retail deposits	74.2	66.5	76.1	70.3
Large time deposits	9.1	11.1	6.3	6.4
Federal Home Loan Bank advances	9.5	9.6	11.4	10.1
Other	7.2	7.4	5.6	8.3
Total	100.0	100.0	100.0	100.0
Memo				
Number of thrifts	3,050	2,627	237	520
Total assets (in billions)	\$ 622	\$1,067	\$ 64	\$ 183

Note: Solvency determined under generally accepted accounting principles. "Other" assets include goodwill and other intangible assets, fixed assets, real estate, deferred net losses, and assets sold.

Source: James R. Barth and Michael G. Bradley, "Thrift Deregulation and Federal Deposit Insurance," paper presented to a conference at the Federal Reserve Bank of Cleveland in November 1988.

accounts to money market mutual funds to take advantage of the double-digit interest rates that insured depositories could not legally offer. If Regulation Q had not been repealed the bank and thrift industries would have collapsed from a shortage of funds.

The charges against asset deregulation pose more interesting questions. Compared with their solvent counterparts, insolvent thrifts have invested substantially greater proportions of their funds in commercial mortgages and direct investments, two asset categories that were liberalized (see table 2). This pattern is even more pronounced among state-chartered thrifts in California, Florida, and Texas — the three states with the broadest thrift powers — where according to a recent *American Banker* survey, nearly half of the nation's GAAP-insolvent thrifts are located (see table 3).

Critics of deregulation conclude that the broader powers given to thrifts led directly to the rising failure rate in the industry. In some individual cases, that conclusion might well be justified. But the more important causes of thrift problems, at least through the mid-1980s, were lax supervision and weak capital standards. During its first term the Reagan administration cut the number of thrift supervisors while the Bank Board let purchasers with weak capital commitments into the industry. In combination, these factors allowed over 400 thrifts to sink into insolvency by 1985.

Had these thrifts been closed or merged quickly, the cost to the FSLIC might have been about \$20 billion instead of the \$100-plus billion it is today. But when Congress and the administration did not provide enough funds to liquidate or merge the troubled thrifts, the Bank Board granted them forbearances from prevailing capital standards and hid their financial condition with artificial "regulatory accounting principles." According to James Barth and Michael Bradley of the Bank Board staff, more than 60 percent of the GAAP-insolvent thrifts operating in June 1988 had been insolvent for at least two years; 35 percent had been in that condition for at least four years.

Allowing insolvent thrifts to stay in business was a

recipe for disaster. Forced to pay premium interest rates to attract deposits, these institutions could not hope to return to health by sticking to residential mortgage lending, whose profitability was declining because of increased competition from mortgage bankers (who quickly sell the mortgages they originate and thus do not need to gather deposits). Instead, many of these "zombie" thrifts — a term coined by Professor Ed Kane of Ohio State University — attempted to climb back to health by rolling the dice, making high-risk, nontraditional investments with their federally insured deposits.

Federal deposit insurance, too, has played a role. Although it has succeeded in deterring deposit runs, the insurance system has proved to be a Faustian bargain, gradually weakening incentives for managers of depository institutions to avoid excessive risk. In particular, the leverage opportunities provided by weak net-worth requirements helped fuel the rapid growth of many thrifts that later failed because of imprudent (and often illegal) investments. Moreover, in recent years, federal regulators have routinely extended guarantees to accounts above \$100,000 in large banks and thrifts (such as Continental Illinois, First Republic Bank of Texas, and American Savings & Loan of California) to avoid runs from these larger depositories. Depositors consequently have had little incentive to monitor the health of the institutions they entrust with their money. It is revealing, for example, that the institutions with the largest loan commitments to Latin American debtor countries are the major "money center" banks, which federal regulators have deemed "too large to fail."

The Immediate Task

The immediate challenge for federal policymakers is simple, if painful: all insolvent banks and thrifts must be removed from the financial system as quickly as possible. We believe that can be done within two years. To take longer would not only postpone the day of reckoning but increase the costs.

Percentage of:	Commercial Mortgages	Junk Bonds	"Equity at Risk" Investments
All thrifts	37.7%	0.3%	3.2%
Solvent thrifts	33.4	0.3	1.7
Insolvent thrifts	59.9	0	11.5
Federal thrifts	35.7	0	1.5
State thrifts	40.4	0.8	5.5
California thrifts	66.5	2.5	10.5
Florida thrifts	58.2	1.4	6.2
Texas thrifts	72.3	0.4	17.0

Table 3. Taking the Risks

(percentage of thrifts with 10 percent or more of their assets in nontraditional investments in June 1988)

Note: Solvency is determined under generally accepted accounting principles.

Source: Barth and Bradley, "Thrift Deregulation and Federal Deposit Insurance."

In addition, barely solvent banks and thrifts must raise their capital levels to the higher standards outlined in the administration's rescue plan. Institutions that fail to comply should be auctioned off or liquidated. Behind these relatively simple principles lie several controversial questions of implementation.

How Should "Insolvency" Be Defined? Initially, generally accepted accounting principles should be used to determine insolvency. Eventually, however, bank and thrift regulators should use *market-value* measurements to determine when to auction off or close the institutions they supervise. The historical cost valuation of assets required by GAAP means little to an insurer forced to liquidate an insolvent institution with assets whose market values are well below cost. Only when its assets and liabilities are "marked to market" can depositors, investors, and regulators know an institution's true condition — the magnitude of the cushion available to the deposit insurer and the amount of capital shareholders actually have at risk at any one time.

Critics claim that market-value accounting will not work for assets that are not regularly traded. But such assets can always be valued by referring to close analogies. Market prices of mortgage-backed securities could be used to value mortgages held directly, for example. Where no easy reference exists, assets and liabilities can readily be recorded at their net present values at prevailing interest rates (using standard formulae for discounting assets that promise payment in the future). For example, a 30-year mortgage yielding a fixed rate of 10 percent a year is worth less when interest rates rise above 10 percent and more when they fall below 10 percent. Adjustments for interest rate fluctuations cannot capture any deterioration in the creditworthiness of the borrowers that might be reflected in a decline in the value of the underlying collateral. But such adjustments could go a long way toward providing a more accurate picture of a depository's true financial health than the current historical cost valuation methods.

Another criticism of market-value accounting is that an institution with a heavy investment in long-term, fixed-rate assets can quickly find itself insolvent if interest rates move up even a little. Should banks and thrifts have to use an accounting system that would shut these institutions down? The answer is yes if those institutions fund those long-term investments with very short-term liabilities. That kind of maturity mismatching brought the thrift industry to its knees in the early 1980s and should not be encouraged, let alone mandated, by government policy. Now that thrifts are no longer locked into long-term, fixed-rate mortgages by law, market-value accounting can be implemented without bankrupting the entire industry. It would also discourage all depositories from making heavy "interest rate" bets — as many thrifts currently do — and thus make the financial system safer.

We recognize that many banks and thrifts considered solvent under GAAP may be insolvent under a market-value standard — perhaps as many as 500 additional

institutions — and thus candidates for auction or liquidation. Given the substantial resources that regulators will require just to close GAAP-insolvent institutions, market-value accounting should be phased in over several years. Initially, it could be required for monitoring purposes only and then eventually as a basis for taking supervisory action.

Merger or Liquidation? The FDIC and FSLIC generally have found it cheaper to assist the merger of failed banks and thrifts rather than to close them and pay off depositors. In the long run, however, mergers are likely to be less expensive than liquidations only if the acquirers put up substantial capital of their own and thus have economic incentives to operate their new institutions in a prudent manner. Perhaps the most important lesson that regulators should have learned from the 1980s is that capital forbearance — permitting institutions that don't meet prevailing capital standards to continue to operate — encourages managers to take risks in the hope of turning their institutions around. The insurance agencies, and ultimately the taxpayers, bear the losses from these "heads I win, tails you lose" gambles.

The Federal Home Loan Bank Board has been criticized for arranging many merger deals in 1988 that appear on the surface to be thinly capitalized. For example, according to Paul Horvitz, a University of Houston economist and a director of the Federal Home Loan Bank of Dallas, the new investors in 54 of the failed thrifts in Texas under the Board's "Southwest Plan" on average have put in little more than 1 percent of the stated value of assets of these institutions. Bank Board member Lawrence J. White argues that these capital contributions are more substantial than they look because the FSLIC typically guarantees for some length of time new owners against capital loss and yield deterioration on the poorly performing assets held by failed institutions. According to a recent report of the FSLIC's Industry Advisory Committee, through the third quarter of 1988, the new capital supplied by private investors represented 5 percent of the "at-risk" assets held by assisted institutions.

White's contention is no doubt true as far as it goes. But because the Bank Board has not fully disclosed the nature and extent of its guarantees, no one outside the Board has been able to assess the reasonableness of individual assistance agreements. In particular, these guarantees typically phase out over some period, but the public does not know to what extent or even whether the Board's takeover agreements require — as they should — that acquirers post additional capital as the guarantees wind down. Moreover, the Board reportedly has granted liberal forbearances from capital requirements for as long as 10 years, which reduces incentives for purchasers of failed thrifts to avoid undue risks in the future.

The cost to the Board of merging insolvent thrifts has gone up substantially since 1985, from 36 percent of the cost of liquidating them to 89 percent of liquidation costs in 1988. The Board favored mergers because it didn't have the cash necessary for liquidations and because the Treasury,

not the Board, bears the cost of tax benefits given new owners of failed thrifts, namely, using the accumulated losses of the thrifts to offset for tax purposes income from the owners' other businesses. (These tax benefits were sharply curtailed beginning in January 1989.)

Under the administration's proposed reorganization of thrift regulation, the FSLIC will be combined with the FDIC, which will assume overall responsibility for merging or liquidating insolvent thrifts. (The Bank Board will also be brought into the Treasury Department, like its counterpart for national banks, the Comptroller of the Currency.) Once the insurers have additional funds to work with, they will be in a stronger position to negotiate with potential acquirers. But even more needs to be done. Insolvent thrifts should be sold in a true "auction" rather than through the time-consuming and lawyer-intensive process of individualized sale negotiations. To facilitate such auctions, the FDIC should announce a policy setting the minimum capital contributions and years of capital forbearance that it will accept in arranging all future assisted transactions.

Given the poor track record, we are inclined to suggest that the forbearances last no longer than three years, that the institutions pay no dividends during this period, and that acquiring parties supply capital initially equal to at least 3 percent of the assets they will have at risk after the transaction. In addition, Congress should require the regulators to disclose the nature of the guarantees, their duration, and the basis for calculating their estimated value, as well as the capital acquirers are required to bring to the institution during the life of the guarantees.

Some observers have urged liquidation of all insolvent thrifts that in auction cannot attract sufficient capital to meet prevailing capital standards immediately. Because such a policy would require the FSLIC to pay off all depositors in all failed thrifts, the immediate outlays would be substantial — well over \$100 billion — although the insurer would eventually recoup some portion of this amount from sales of the assets it would inherit. In the interest of conserving the FSLIC's cash, and thus in minimizing immediate outlays, we believe it remains prudent for insurers to assist the sale of insolvent thrifts to new owners who make up-front capital commitments large enough to demonstrate that the thrifts will be able to comply with capital standards in relatively short order. We believe that an initial capital threshold of 3 percent, coupled with forbearances lasting no more than three years, would reduce the immediate cash outlays and minimize the chances that the new owners would gamble their institutions back into insolvency.

Apparently in response to a suggestion made by the General Accounting Office, the FDIC plans at this writing to take control of more than 200 insolvent thrifts to reduce the upward pressure they place on interest rates and to prevent further risk-taking. That could be a useful step, but only if substantial additional funds are soon made available to the insurance agencies to meet the liquidity needs of these thrifts. The FSLIC's experience with a similar effort — the Management Consignment Program — teaches that

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unless those funds are provided, the thrifts will have to bid up interest rates to attract new deposits to cover losses on their current operations.

What About "Distressed Assets?" With limited forbearances, the number of liquidations would likely increase. That means the insurers would inherit from liquidated depositories a sizable number of "distressed assets" — mortgages and other loans in default and foreclosed property, either empty or partially rented buildings or undeveloped land. Since the federal government is not and should not be in the real estate development and management business, every attempt should be made to auction these distressed assets to private investors rather than to hold them indefinitely — which appears to have been the policy at the FSLIC.

Nevertheless, in certain areas such as Texas, where real estate markets are already extremely weak, auctions could yield fire-sale prices, which could depress local construction activity and produce little revenue for the deposit insurers. To avoid those consequences, the auction program should be spread out over no more than five years. As a general rule, mortgages and other interest-bearing assets and completed structures should be auctioned immediately unless overwhelmingly concentrated in one or more specific local markets. A more gradual, but orderly, auction program should apply to undeveloped land.

Under no circumstance, however, should the fire-sale problem be used as an excuse to slow the closure of insolvent institutions. As unpalatable as it may be for the government, warehousing real estate is surely less costly

than warehousing insolvent institutions. Unlike distressed real estate, which may eventually appreciate in value, insolvent thrifts and banks are virtually certain to continue to *lose* money.

Who Should Pay? The critical bottom-line question is who should pay for cleaning up the insolvency mess? For insolvent banks, the answer is straightforward: the FDIC probably has sufficient reserves to cover current bank failures, but there is not much room for error.

FSLIC's massive insolvency can only be cured by an infusion of substantial new resources. The cheapest way to do that would be for the Treasury itself to issue bonds. It is widely assumed, however, that any Treasury borrowings will automatically increase the federal budget deficit and therefore should not be pursued. But in this particular case, the borrowings initially would have no macroeconomic effects. Interest rates would not be affected because any increase in the demand for credit caused by the additional government borrowing would automatically be met by an increase in the supply of credit when the government pays off depositors or assists the merger of failed institutions. Similarly, simply receiving funds that they had on deposit should not cause insured depositors to make major changes in their spending plans. In short, because Treasury borrowings for this special purpose would have no economic effects — unlike other government spending programs — there are sound economic reasons not to record them on the budget.

Nevertheless, the working assumption that Treasury bonds would increase the budget deficit has driven the administration to propose an alternative financing plan that would keep most of the rescue costs off-budget. Under that plan, FICO would be superseded by a new agency, the Resolution Funding Corporation (RFC), authorized to issue \$50 billion in bonds over a three-year period. The initial bond issue would be off-budget. To finance those bonds, the agency would purchase \$50 billion in face value of Treasury zero-coupon bonds set to mature when the RFC bonds mature. At current interest rates, the purchase price of the "zeros" would be approximately \$5 billion, which would be raised from the thrift-owned Federal Home Loan Bank System and deposit insurance premiums collected by the FSLIC.

The FSLIC and the Treasury would pay the interest on the RFC bonds, roughly \$5 billion a year. To cushion the impact on the federal budget, deposit insurance premiums would be increased. Bank premiums would go up in two stages to 15 basis points, from 8.3; thrift premiums would go up to 23 basis points, from 20.8 (and then down to 18 basis points in 1994). The impact of the increase is lessened somewhat because the institutions may deduct the premiums for income tax purposes.

The political prospects for the administration's proposal are reasonably good because it spreads the cleanup costs among taxpayers, depositors, and the bank and thrift industries. Taxpayers would ultimately bear the burden of the interest Treasury pays on the RFC bonds. Depositors would shoulder some of the burden because banks and

thrifts are likely to pass on much, if not most, of the higher premiums by lowering interest rates on deposits. The proposed premium increase is sufficiently modest that the bulk of it could probably be passed on without triggering severe protest from depositors or significant outflows to money market funds. Interest rates on deposit accounts often vary from month to month by about as much as the proposed premium increase.

Finally, bank and thrift profits would be reduced by the portion of the premium increase they are unable to pass on; however, healthy banks and thrifts would benefit because they no longer would have to pay higher interest rates to compete with insolvent institutions. In addition, the thrift industry would bear the cost of the required capital contribution from the Federal Home Loan Banks.

The proposal also attempts to avoid the "tax increase" label — an anathema to the administration, given the president's "no new taxes" pledge. The administration justifies the proposed premium increase as a prudent measure to protect insurers against future losses, rather than as a penalty for costs already incurred — which would make the increase look very much like a tax. In addition, the administration notes that the additional premium revenue would not be used to pay interest on the new RFC bonds, and therefore would not pay for past problems, but instead would simply offset the negative budgetary consequences of Treasury's financing of the RFC bond interest.

Despite its apparent political feasibility, however, we believe that the plan contains several significant shortcomings. First, and most important, the \$50 billion in additional bonds for new thrift mergers and liquidations very likely will not be enough to close all insolvent thrifts. As we have already indicated, at least \$32 billion and as much as \$65 billion will be required to deal with the 350 GAAP-insolvent thrifts. Additional funds will be needed to handle the future insolvencies of many institutions now solvent under GAAP measures but insolvent on a market-value basis. And the estimated \$38 billion in guarantees the Bank Board made in 1988 may understate their value. All this means that this or a future administration may have to go back to Congress for additional borrowing authority.

Second, the proposal to spread the bond issues over a three-year period reduces the ability of the insurers to move quickly. As a result, many institutions that should be merged or liquidated immediately will be permitted to run additional losses, adding to the final cleanup tab.

Third, the proposal to issue the bonds through the RFC rather than through the Treasury needlessly raises the cost of the rescue. Even if Congress extends a federal guarantee to any RFC bonds, it is highly likely that RFC would still have to pay higher interest. Bonds issued by the Farm Credit Association carry a federal guarantee but still must pay a premium of approximately 40 basis points, or four-tenths of a percent. If this same premium were to apply to \$50 billion of RFC bonds, taxpayers would have to pay an additional \$200 million in interest each year (above

Table 4. Federal Deposit Insurance Reform: How to Mimic the Market

Private Practices	Deposit Insurance Practices	Reform
Risk-sensitive premiums	Flat-rate premiums	Set risk-sensitive premiums
Actuarially fair insurance premiums	Premiums too low to cover abnormal losses	Raise premiums
	Doubt about who will pay abnormal losses	†Make explicit who pays for abnormal losses
Deductible to reduce moral hazard and adverse selection	*Reduced minimum required capital levels	†Raise minimum capital standards
	*Thrift and bank capital depletion	Use risk-sensitive capital standards
Conduct and performance standards for insured	Inconsistent standards between and among thrifts and banks, and federal and state governments	†Set uniform regulations
	*Insolvent thrifts and banks open	†Close all insolvents
	*Wider asset and liability powers for insolvents	
	*Reduced supervisory intervention during deterioration (forbearance)	
Insurance cancellation and stop-loss provisions	Difficult to rescind insurance once chartered	†Create narrow or marketable bank
	De facto 100% deposit guarantee	Roll back deposit insurance
	Large institutions too big to fail	
	Closure only after losses have occurred	†Close institutions before insolvent
Monitoring of insured condition	Historical cost (book value) accounting	†Adopt market-value accounting
	*Reduced reliability of book-value accounting under Regulatory Account Principles	
	*Reduced examination capability as institutions deteriorated	
*New deviations from private insurance practices in the 1980s		†Proposals the authors recommend

the Treasury rate). Discounted at current interest rates over the 30-year life of the bonds, the additional interest cost would be about \$2 billion.

Fixing the Fundamentals

Policymakers should act quickly and decisively to remove the nation's insolvent thrifts from the system. But solving the short-term problem will not reach the underlying factors that allowed the crisis to develop. Congress and the Bush administration should therefore take steps to ensure that similar crises cannot develop in the future. In order of importance, these reforms should include an overhaul of the deposit insurance system, an update of the laws governing the structure of the nation's financial system, and a melding of the banking and thrift industries and their regulatory apparatus.

Deposit Insurance. The challenge in reforming deposit insurance is to preserve its stabilizing features while encouraging managers of insured depositories to avoid

excessive risks. We believe that could be accomplished by requiring the FDIC and FSLIC to adopt some of the practices that private insurers use to limit their own risks and those of their insureds (see table 4).

It is unlikely that all private practices, however, will succeed when applied to depository institutions. For example, many economists once believed that instead of flat-rate insurance premiums, depository institutions should pay premiums based on the level of risks they assume. Knowing that they would have to pay higher premiums if they wanted to take higher risks, banks and thrifts would presumably be more cautious. But now most analysts question whether regulators can accurately differentiate *beforehand* the risks different institutions pose to the insurance fund. After all, at the beginning of the decade, many banks that later failed looked like sound, well-run institutions. Only in hindsight could regulators see what went wrong.

Another often-discussed proposal, recently supported by President Reagan's Council of Economic Advisers,

would reduce deposit insurance coverage to encourage depositors to exert increased discipline on banks and thrifts. In principle that strategy might help; in practice it could face high hurdles. Large depositors would probably split their deposits into smaller denominations and place them in a larger number of institutions — ensuring total insurance coverage but not necessarily exercising any discipline. More important, as long as federal policymakers prevent runs by fully guaranteeing the accounts of even uninsured depositors at large failed institutions, a lower insurance ceiling will provide no additional depositor discipline.

We believe the only sure way to instill greater discipline in the banking system is for regulators to enforce capital standards and to take custody of troubled depository institutions *before* they become insolvent — much as private insurers enforce conduct and performance standards and require stop-loss provisions. The administration proposes to give thrift regulators discretion to intervene early. We believe that an early intervention policy should be mandatory for all depository institutions, as previously advocated by author Brumbaugh, George Benston, and George Kaufman, and more recently by the Shadow Financial Regulatory Committee, an independent group of market-oriented experts on the banking system. Congress should direct the regulators to auction or close an institution when its net worth falls below a specified level, say, 3 percent of assets. To avoid due process problems, any proceeds from a forced auction or liquidation should be returned to the shareholders of the institution.

It is encouraging that the Federal Home Loan Bank Board has recently proposed a rule that would allow it to take custody of thrifts whose net worth is below 1.5 percent of assets. The Board's proposal would be much improved, however, if it were based not on GAAP accounting, but on market-value accounting, as Board member White and many academic experts have advocated. Using market values to trigger supervisory action would sharply curtail any legal haggling about the true net worth of an institution and thus vastly streamline the legal procedures for early intervention.

The administration's plan also would allow the FDIC to raise deposit insurance premiums up to 35 basis points in incremental annual steps if it believes that it is exposed to a risk of "serious future losses." That is a potentially useful suggestion but only if the FDIC's premium-raising authority is specifically tied to a moving average of the insurer's losses in prior years, as FDIC Chairman L. William Seidman recently advocated. Not only would that reform prevent slow erosion of the insurance funds, it would also provide powerful incentives for healthy institutions to insist upon regulatory measures that reduce failure rates and thus their required deposit insurance premiums.

In particular, loss-based premiums would encourage sound banks and thrifts, even small ones, to work more aggressively for interstate branching, which would help diversify lending risks, and to support early intervention regulatory policies based on market-value accounting.

These political incentives are important because, if this decade has taught anything, it is that institutions threatened with closure or takeover can be expected to generate political support to delay or stop the regulators. But if regulatory action is made mandatory and self-evident under a market-value accounting policy, and if healthy institutions have a vested interest in supporting early intervention in particular cases, then chances are good that any political intervention on behalf of the targets of regulatory action can be defeated.

Financial Restructuring. Eventually, if only to stay competitive in international markets, the United States must reform its outdated financial laws, which currently prevent the formation of companies that offer a complete menu of banking, securities, insurance, and real estate services. Canada has already moved in this direction. The European Community is expected to follow suit as part of its "1992" integration effort and may keep American financial institutions from expanding their operations there unless U.S. laws are patterned more closely on the European model of "universal banking." Meanwhile, the United States has lagged behind, largely because the various financial industries have lobbied each other to a stalemate in Congress.

We believe a sensible way to break the deadlock is to structure a solution around a modification of the "narrow," or "safe," banking structure that author Litan has previously proposed in the *Brookings Review* (Fall 1986) and in other publications. In its original version, the safe banking proposal would have allowed any organization to own banks and offer other financial services as long as all of its banks invest their deposits solely in government securities or in instruments issued by quasi-governmental agencies. The safe-banking asset requirements would not have applied to small banks, whose powers would continue to be subject to state law.

The safe-banking concept was designed to ensure the safety of all banks belonging to any conglomerate, be it financial or commercial. Critics have argued, however, that the asset requirements for safe banks are too narrow and would sharply limit the potential profitability of the safe-banking option. This criticism can be accommodated while preserving the safety of the proposal by modifying it along lines recently suggested by Jack Guttentag and Richard Herring of the University of Pennsylvania.

The Guttentag-Herring plan would allow the safe banks to invest in any "marketable" assets, thus broadening permissible investments to include commercial paper, asset-backed securities, municipal bonds, corporate bonds, and even corporate equities. The assets and liabilities of safe banks would be valued at market rates; thus, these banks would be readily subject to early intervention policies.

Reasonable people can question whether the list of marketable assets permitted under the Guttentag-Herring concept is too broad — specifically, whether safe banks should be permitted to invest in corporate equities. But the core "marketability" concept in their plan, as in

the original safe-banking proposal, should apply to all banking organizations under any reform of the law governing financial structures.* In late January 1989, Senator Christopher Dodd introduced legislation (S308) that contains these features.

Merging Thrifts and Banks. The final important question raised by the current savings and loan crisis is whether separate thrift industries should be continued. Is it in the public interest to maintain a set of specialized depository institutions regulated by a separate agency (the Federal Home Loan Bank Board) and required to invest a substantial portion of their assets (60 percent) in residential mortgages to receive certain tax benefits and to be eligible to borrow from a specialized lender (the Federal Home Loan Bank System)? The answer is no.

Consider each of those characteristics. First, Americans already have substantial incentives to purchase their own homes through the mortgage interest deduction, which currently costs the Treasury about \$20 billion a year in lost revenue. If more tax incentives for home ownership are desired (a dubious proposition), it is more efficient to give them directly to home buyers than to channel them through a set of specialized housing lenders.

Second, the Federal Home Loan Bank System is currently an important source of liquidity for the thrift industry, supplying advances that account for about 10 percent of the industry's funds. With the development of a vast private market in mortgage-backed securities, however, the purpose of the Home Loan Bank System is no longer clear. Even if a case for the system exists, it does not justify separately chartered thrift institutions. The system could instead be directed to make funds available to any depository institution that invests more than some minimum fraction of assets in residential mortgages.

Third, establishing a special regulatory system for the thrift industry was a mistake. The Bank Board historically has had close ties to the thrifts it regulates; critics contend that it has been "captured" by the industry. We suspect that the major reason many thrifts want so desperately to maintain their separate status is to hang on to the specialized regulatory apparatus that has grown around the industry. That should be reason enough to end it.

At bottom, the real reason for ending the special treatment of thrifts is that they are no longer necessary either to originate or to hold residential mortgages. The so-called "securitization" movement — the development of securities backed by packages of mortgages originated by thrifts, banks, and mortgage bankers — has sharply reduced thrifts' share of originations to about 40 percent. Perhaps more significant, in a recent paper presented at the 1988 annual meeting of the American Economic Association, author Brumbaugh and Andrew Carron of First Boston showed that thrifts have displayed no special tendency to originate mortgages when the mortgage market is tight — that is, when interest rates have risen. This finding squarely contradicts claims that thrifts are the only stable source of mortgage credit in times of need.

To a lesser but still significant degree, many institutions

other than thrifts — banks, insurance companies, pension funds, and mutual funds — now also hold mortgage instruments in their portfolios. Indeed, under the new risk-based bank capital standards, banks have greater incentives to invest in mortgages and mortgage-backed securities because these instruments require less capital backing than conventional loans.

Nevertheless, thrifts collectively hold about \$1 trillion in mortgages (directly or in the form of securities), a vast sum that cannot be absorbed immediately by other purchasers. For this reason, the legal, tax, accounting, and regulatory distinctions between banks and thrifts cannot be eliminated overnight. A transition to a single depository industry with a single insurer should be gradual, occurring over 5 to 10 years. The administration proposal avoids the politically controversial issues such a transition would pose. But by administratively merging the FSLIC and FDIC and bringing the Bank Board into the Treasury Department, it at least lays the foundation for eliminating the arbitrary distinction between banks and thrifts.

Moving toward a unified depository industry would not jeopardize the availability of mortgage finance. Instead, different depository institutions could be expected to target different parts of the financial market. Some will concentrate on mortgage lending, like today's thrifts. Others will behave like today's commercial banks. But with stronger capital standards, market-value accounting, and early closure policies in place, insured depository institutions will be a lot stronger and more efficient than they have been in this turbulent decade.

Passage of any of these reforms will not be easy. Congress began to explore possible changes to the deposit insurance system seven years ago but has not made any substantial revisions. Vehement disagreement among banks, thrifts, securities firms, insurance companies and their agents, and real estate brokers about how the nation's financial services industry should be restructured has thwarted congressional action. And the heated debate over ending the distinctions between commercial banks and thrifts promises to do the same.

In short, if past history is any guide, progress on fundamental reforms will be slow. Nevertheless, the current thrift and bank crisis offers a unique opportunity for Congress to put together a sweeping overhaul of the nation's deposit insurance and financial systems. Congress and the administration should work toward this objective. But taking care of the current crisis is so important — and further delay so expensive — that if at any point it appears that resolution of these fundamental issues will significantly slow the recapitalization or the closing of insolvent thrifts, policymakers should put the rescue package in place before attending to the longer run issues.

*Brookings will publish shortly a *Blueprint for Restructuring American Financial Institutions*, written by Professors George Benston, Jack Guttentag, Richard Herring, George Kaufman, and Kenneth Scott and authors Litan and Brumbaugh, which will outline this "marketable bank" concept in greater detail.

Can Divided Government Be Made to Work?

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President George Bush and the Democratic leaders of Congress have begun their four (or eight) years of compulsory coexistence with the usual promises of genuine collaboration in attacking the nation's problems. But such promises in the past have invariably turned out to be empty rhetoric. In each of the recent periods when Republican presidents were forced to share power with Democratic congressional majorities, cooperation quickly degenerated into conflict, recrimination, and immobility. The separate branches of the government went their separate ways on crucial issues of domestic and foreign policy, and the government proved incapable of coping with major issues that confronted it.

Not in all cases, of course. Dwight Eisenhower and the Democrats in Congress worked harmoniously on matters of foreign and military policy. Ronald Reagan marshaled enough Democratic support to enact the essentials of his economic program in 1981, and a high degree of bipartisanship was subsequently achieved in rescuing the Social Security system, reforming the tax code, and taking steps to curb illegal immigration. But the negative side of the ledger contains a longer list of failures. The Eisenhower years were marked by virtually total stalemate on the whole range of domestic issues. Richard Nixon and Gerald Ford were in continuous, and usually fruitless, struggle with the legislature, on foreign as well as domestic policy.

In the Reagan era, one need not look beyond the budget crisis to discern the impotence of government. Leaders of both parties, in both branches, were united in bewailing the size of the budget deficit, but together they did nothing but flounder for half a dozen years in trying to reduce it. President Reagan had his approach; the Democrats rejected it. They in turn floated suggestions; the president promised in advance to veto them. It finally took a half-trillion-dollar collapse in the stock market to get the two sides even to sit down together, in their late 1987 summit meeting at which their essential decision was to temporize until after the 1988 election. It is a measure of the incapacity of divided — or coalition — government that it was easier for Mikhail Gorbachev to get his summit meeting with the president of the United States than it was for the Speaker of the U.S. House to do so.

All this is to be expected when the government is divided between the parties. Political parties are organized not for collaboration but for combat. They are formed because people have deep-seated differences about the goals and policies of government, and to achieve its goals a party must defeat its opposition. Party rivalry is healthy — indeed essential — in a democracy. But when each of the major parties controls its own branch of government, then the institutions of govern-

ment themselves are thrown into conflict, impelled by the dynamics of party competition to attempt to discredit and defeat each other.

The United States has never learned how to operate a coalition government successfully, nor even given the problem much attention. During most of American history, after all, the problem did not exist. The voters normally gave a newly elected president a Congress of his own party to support him; they did so in 17 consecutive presidential elections from 1888 through 1952. But with the second Eisenhower victory, in 1956, the country went through a momentous political transition, from an age of unified party government almost all of the time to one of unintended and unwilling coalition government most of the time. From 1955 through 1990, Republican presidents will have occupied the White House for 24 of the 36 years but without for even a single year enjoying the support of a Republican House of Representatives, and with a Democratic Senate also in every year but six.

That minority of voters whose ticket-splitting produces divided government (at least three-quarters of the electorate votes for the same party's candidates for president and House, it should be emphasized) appear to assume that their chosen leaders will somehow get together when the national interest requires it.

They should, of course. Indeed, they must. But to do so is hardly natural. A Republican president can never be the accepted leader of a Democratic Congress. He is, after all, the man the majority of legislators strove valiantly to defeat in the last election and will do their utmost to vanquish in the next. When he sends a proposal to Congress, Democratic majorities are virtually compelled to reject it; otherwise they enhance the president's stature as a leader and build him up for that always-imminent next election. By the same token, if the Democratic Congress initiates a measure, the Republican president is obliged to veto it, lest he acknowledge his political opponents as wise and prudent statesmen who deserve the public's confidence — and votes.

So how can the United States make its peculiar form of coalition government succeed? Somehow, behavior must be changed.

To begin with, presidents will have to stop "throwing down a gauntlet to Congress" and "challenging [it] to epic battle," as Richard Nixon in his memoirs boasted he had done. In George Bush's own words, presidents will have to proceed in a kinder and gentler fashion. And the legislators will have to respond in kind.

It is just possible that the change will come about spontaneously. Personally, I doubt it. I think the temptation to jockey for partisan advantage will still be overwhelming — as it was during the Eisenhower, Nixon, Ford, and Reagan years. If either side sees the opportunity to gain political advantage by rejecting the advances of the other, it will do so. Remember, George Bush did not win his presidential nomination by promising to do business with Democratic liberals, and George Mitchell was elected to the leadership of the Democratic Senate because his colleagues saw him, not as the most adept at compromising, but as the most effective battler for their party's principles.

Since parties simply must maintain their principles — up to a point — what the United States has to invent are institutional devices that enable the parties to do just that separately while

they jointly accomplish the business of the government. That may sound like a contradiction in terms, but the experience of other countries may point the way. Some successful democracies have long experience with government by "grand coalitions" of the liberal and conservative parties — notably the Netherlands, Belgium, Switzerland, and Austria. The Scandinavian countries, whatever party or parties may hold power, have a tradition of formulating policies by consensus of all the major parties. Granted, these are all small countries, but the lessons are instructive.

The key to success in those countries appears to lie in the development of bipartisan (or multipartisan) institutions that remove crucial issues from the arena of hurly-burly politics and allow them to be resolved by people whose electoral interests are not immediately at stake. The institution may take the form of a summit committee made up of responsible party leaders whose status within their parties is secure, or — more commonly — of a negotiating commission composed of authoritative representatives of the leading factions with a mandate to devise the necessary compromise. In Sweden almost every major question is referred to a multiparty commission of some sort before being considered by the legislature. In the Netherlands the Social and Economic Council is a standing body that, though advisory, is described as an effective and powerful economic parliament.

The bipartisan, or multipartisan, commission has an enormous advantage. It enables the vulnerable politicians who must face the voters to maintain their principled positions publicly while compromising them out in secret. That may have a somewhat sleazy ring, and appear corruptive of the democratic process, yet on the occasions when such an approach has been successfully used in the United States it has been hailed as masterful political craftsmanship.

The best example from recent American history was the commission headed by Alan Greenspan in 1983 that resolved the crisis facing the Social Security system. Its plan called for

unpopular actions, but once the commission reached its compromise behind closed doors and stood solidly in support of it, Republicans and Democrats alike could hide behind that authoritative body. House and Senate leaders fought off all amendments, and the commission's plan was adopted intact. Elected officials could go home and tell their constituents, in effect, "I myself was against it, but I had no choice."

Members of Congress who sponsored the bill creating the National Economic Commission that is now grappling with the budget deficit used the Greenspan commission as their model. The legislators foresaw using the economic commission as a shield, too, when it came time to accept what they saw as its inevitable, unpopular recommendation that taxes be increased. Unfortunately, its ability to negotiate and compromise was drastically limited — at least during its first year — when President Bush took his adamant campaign stance against any form of tax increase. The NEC may turn out to be an object lesson in how *not* to use the bipartisan commission device as a form of conflict resolution.

Whether or not this particular effort is discredited, the nation must continue to grope along this path toward the development of institutions that will make the new American system of coalition government work. Bipartisan negotiating mechanisms, ranging from regular leadership meetings at the White House to more formal summit conferences to ad hoc committees to independent commissions, will need to be used not just occasionally but regularly, and to anticipate and forestall crises rather than simply to try to deal with them when they reach the desperation stage.

Such systematized collaboration will be cumbersome, but if the country is to learn how to manage its affairs through the coalition governments that the voters will continue to bestow upon it, probably most of the time, it must devote imaginative attention to designing the innovative institutions that will be adapted to the changed circumstances.

Governing the \$5 Trillion Economy

Herbert Stein

Discussion of federal budget policy in the United States has fallen to an abysmally low level. It consists wholly of bumper-sticker slogans, sound bites, lip reading. It finds public expression in shibboleths like no new taxes, balance the budget, don't raid Social Security. Prescriptions for dealing with the budget evade the central problem, which is making choices. Instead the nation is treated to the arbitrariness of balanced-budget amendments, constitutional limits on spending, Gramm-Rudman-Hollings formulas, freezes, flexible freezes, and across-the-board cuts.

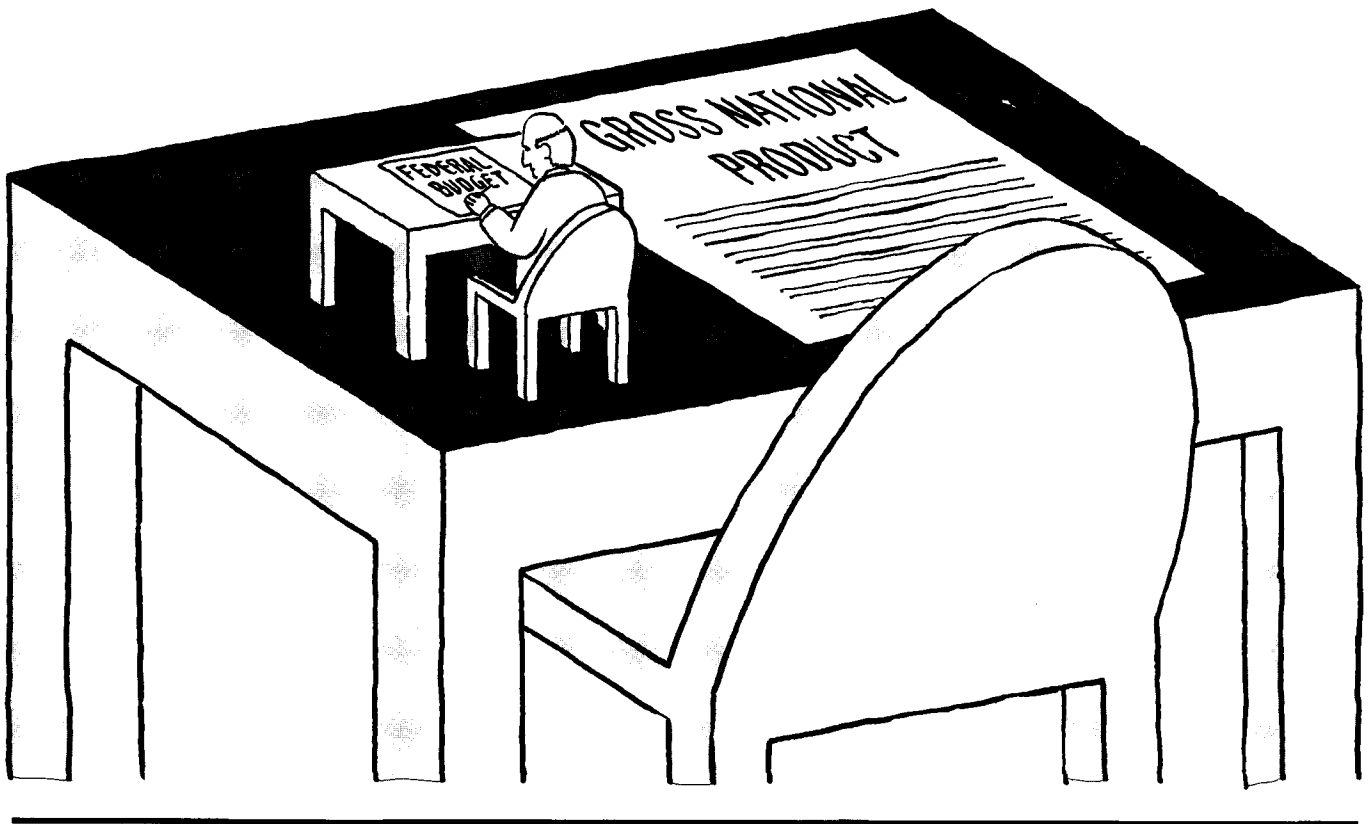
None of these supposed cure-alls takes into account the consequences of budget policy. Budget decisions have three kinds of effects. One is on the allocation of government expenditures among the hundreds of agencies and thousands of programs of the government, which I call the micro-allocation function. A second consequence of budget policy is its effect on the stability of the economy — the fluctuations of total output, employment, and the price level. This effect is the one that preoccupied the generation after the Great Depression of the 1930s. It is still important. But the effect that I am most concerned about is the effect budget policy has on the allocation of the national output.

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It is this effect that determines whether we further our national objectives; it is this effect that is most neglected and that needs attention.

The allocation problem has changed greatly since 60 years ago. In Calvin Coolidge's time, the budget problem was how to allocate a tiny fraction of the national output — about 3 percent — among a number of uniquely federal uses, such as national defense, administration of justice, care for veterans, and the post office. The federal government did not much affect — and did not have much interest in — how the other 97 percent of the output was used.

Today the federal government uses a much larger share of the national output, more than 20 percent of the gross national product (GNP). It also affects much more profoundly and intimately how the rest of the national output is used — and it does so intentionally. Most of the government's expenditures are for purposes that it did not serve 60 years ago and that are also served by the private sector and by state and local governments. Sensible decisions about those expenditures can only be made after considering the total national provision for those purposes, and not just the federal provision. Much federal action is designed to affect the nonfederal allocation of the GNP by incentives of various kinds. The government's taxes, transfers, and borrowing significantly influence the division of private income between consumption and investment. Tax treatment of fringe benefits affects how much private income is spent for medical care. Tax treatment of mortgage interest affects private expenditures for housing. These effects are recognized in a special analysis of the budget,



called "tax expenditures," but they are not integrated into the decisionmaking process about the budget. Moreover, other government policies, such as various regulations and loans, also affect substantially the allocation of the national output but receive no systematic attention in the budget process.

To correct these serious omissions in federal budget-making, I suggest that the process begin with decisions about the allocation of the national output among the major uses of it. Federal decisions about taxes, expenditures, borrowing, regulation, and loans should be regarded as means for achieving the desired allocation of the national output and should be consistent with that allocation. In other words, we should budget the \$5 trillion GNP before we start budgeting the \$1 trillion that the federal government spends.

The deficit is *not* the heart of the budget problem. But it can illustrate what I mean by budgeting the GNP. Almost everyone says that the budget deficit must be reduced, yet can rarely say why or explain what difference it makes. The deficit does make a difference; it absorbs saving that would otherwise be productively invested and so reduces future levels of output. The deficit is important because it affects a certain real use of the GNP. If we want the deficit to be smaller, it is because we want that particular use, which is investment, to be larger. But if we want investment to be larger, some other use of the GNP has to be smaller. At any moment there is a limited amount of available national output; increasing some use of that output therefore requires decreasing some other use. As

the Communists used to say, whoever says A must also say B. Or as the conservatives say, there is no free lunch. Once we recognize the logical implication of a reasoned desire to reduce the deficit, we are in the domain of budgeting the GNP, of thinking about how the GNP should be allocated.

At this point it becomes clear the decisions about the conventional federal budget are only instruments for affecting the allocation of the GNP. Raising or lowering the deficit is a means of affecting investment. Raising or lowering taxes is a means of doing something about consumption. Changing the rules for reimbursement under Medicare is a means of doing something about that share of the GNP devoted to health care. My proposal is that we should make these instrumental decisions so that they are consistent with explicit decisions about how the GNP should be allocated among major uses.

I am not suggesting that the government should be making detailed decisions about the allocation of the national output. I only want the government to make explicit decisions about the "grand divisions" of the national output with which it is inevitably involved and in which there is generally agreed to be a national interest.

In my view, the uses it is appropriate to consider are defense; education; health; consumption by the very poor, excluding health care; consumption by the nonpoor, excluding health care; investment by Americans, including government capital not included elsewhere; and other government functions. Other people would have different views of what the appropriate categories should be. Some

"To correct these serious omissions in federal budget-making, I suggest that the process begin with decisions about the allocation of the national output among the major uses of it In other words, we should budget the \$5 trillion GNP before we start budgeting the \$1 trillion that the federal government spends."

might want to include housing or net exports or research as separate categories, which would require rearrangement of the others. The classification is not important. What is important is that people who talk about the budget should be explicit about their priorities for the uses of the GNP, according to their own standards, that the categories should be exhaustive, and that the number of categories should not be too large for a single mind to grasp and compare.

The decisions about the grand divisions of the national output would have to be implemented by policy — by taxing, spending, borrowing and lending, subsidies, regulations, exhortations, or possibly other policies. The budgeting of the GNP cannot supplant the budget process that now goes on but should guide and discipline that process. We would understand better the consequences of a particular tax policy if that policy flowed from a prior

decision about the allocation of the national output. We convey more information if we say we will not reduce private consumption than if we say "Read my lips: No new taxes."

If we decide that we want to divert some of the national output from consumption to defense, we still have to decide how to restrict the consumption and how to spend for defense, and the usual questions of equity and efficiency will remain to be solved. But we will make better decisions about the means if we have considered the ends of policy.

Looking at the budgetary problem as one of budgeting the GNP has three major advantages.

First, the allocations of the GNP come closer to defining our ultimate national interests than the allocations of the federal budget do. If a national objective is to improve the educational attainment of the American people, total expenditures for education — private, state, and local as well as federal — must be considered. Sensible decisions about the adequacy of federal expenditures can be made only in the context of total expenditures for education goals. If future economic growth is a goal, the totality of growth-promoting uses of the national output, which are predominantly private expenditures, must be considered before deciding on federal policies, including the federal deficit or surplus, that affect that totality. Budgeting the GNP can create a bridge between national objectives and budget decisions.

Second, budgeting the GNP helps to bring home the basic fact that if the nation wants more of something, it must take less of something else. It always seems possible to meet more of everyone's claims on the federal budget, without sacrificing any, just by increasing the budget. That is not true of the GNP; it cannot simply be made bigger.

Third, allocation of the GNP also shows the nonbudgetary ways in which the federal government influences the allocation of the national output. These influences are of growing importance. As policymakers feel more constrained by the budget situation, they are more tempted to achieve the same objectives by nonbudgetary means — thereby concealing the costs that would have been evident if the budget had been used. For example, one widely discussed idea would institute national health insurance by requiring employers to provide their workers with health coverage. These expenditures would not appear in the budget, and the population would pay through higher prices or lower wages rather than through taxes. This device, and others like it, would not, however, take the costs or benefits of the program outside the GNP.

How the Process Would Work

To carry out the approach to budget decisionmaking that I propose, I suggest the following steps.

First, the president, within a year after taking office, should set out his view of the national priorities. This statement should identify not only the purposes to which he thinks more resources should be devoted, but also those

Breaking with Tradition

I was raised on the belief that while rules for policy might not give the best of all conceivable results, they would give results vastly superior to the product of ignorant, self-interested and short-sighted politicians. At the same time, I have been greatly impressed by how little we know about anything and have always thought that the chief problem in formulating economic policy is deciding what to do when we don't know what to do.

So how does a person who has always believed in the superiority of rules come to propose a process that relies heavily on the discretionary judgment of politicians about matters for which objective evidence is very limited? There are several explanations for my present position.

First, I doubt that the commonly proposed rules for remedying our budget problems, namely, the balanced budget and spending limitation amendments, would yield better results than the politically based process we now follow. The basic rationale underlying these proposed rules is that politicians spend too much; therefore, a rule that limits government spending, directly or indirectly, would be an improvement.

But once you recognize the pos-

sibility that a given government expenditure could be lower than you would like, you must also recognize that tightening the limits on total spending will increase the possibility that the expenditure you care about will suffer. In that case, the rule might lead to an inferior result even though it restricts total spending. Less spending may be worse than more spending if it involves cutting the spending that you think is terribly important.

This conclusion is borne in on me by consideration of defense spending. I think that concern with the deficit and with limiting total spending has resulted in greater danger to the national security than would have occurred with more spending and a bigger deficit. And once I recognize that result for the expenditures that seem vital to me, I have to recognize that others may feel the same way about other expenditures.

Second, I doubt that rules can keep the majority of politicians — and a majority of citizens — from doing something they want to do. Despite all the hue and cry, the politicians have not enacted these proposed budget rules. And there is widespread, if tacit, acknowledgement that if the rules were enacted, real adherence to them

would be almost impossible to ensure. The rules will not be established and observed unless there is greater awareness of the practical reasons for doing so than now exists. And if there were such awareness, the rules would not be as necessary as their proponents claim them to be.

Third, I don't think we have to despair about the possibility of improving the rationality of the present budget process. Thinking and talking about the process has already led to some improvement in our lifetimes.

Fourth, even if the rules were established and observed, they would not answer most of the questions. At most, they might determine the size of the deficit, presumably zero, and the total amount of spending. They could not determine the direction of expenditure or the nature of taxation, issues that could be more important than the size of the deficit or total spending.

Finally, even the most rigorous formulation of budget rules leaves open the possibility of departing from them or changing them, decisions that are a matter of someone's discretion. In short, I do not think we can avoid the challenge to try to learn more and make goal-oriented, functional decisions about the budget.

purposes to which he thinks fewer resources should be devoted. He should recognize that the nation cannot have and do everything and that he is expressing a set of choices. The statement might read like this:

The United States faces a powerful enemy, whose conventional military forces outstrip ours and threaten our security. The United States is very rich, with the highest per capita income in history. But per capita income is growing more slowly than it did in the recent past. However rich we are, the loss of the expectation of rapid, visible improvement in living standards removes an invigorating and encouraging aspect of life in America. Also, even though we are on the average very rich, a relatively small number of people have incomes so low and living conditions so miserable that improvement is a high national priority. Finally, the quality of life in America is worsened, and the survival of a free society itself

endangered, by the illiteracy of too many Americans, by their ignorance and their lack of understanding of our society's values. Thus, the nation's most important goals at this time are to strengthen our defenses, to raise the rate of economic growth, to improve the lot of the poorest among us, and to elevate the understanding of the population. To say that these are the most important objectives is to say that some other things, although valuable, are less important. The chief among these is to sustain the level of consumption of people who are not poor.

I offer this statement because it happens to describe my priorities. But it is only an illustration. The president may have different priorities. He could think that the national security threat has passed, that Americans in general are rich enough and do not need to save much for the future, that the purpose of economic activity is consumption, and

that the highest priority is to divert some of the national output to consumption from defense and investment. Whatever his priorities, his statement of them should be as explicit as possible and recognize the existence of limits — something presidents dislike doing.

Second, the president should submit a four-year plan for the allocation of the GNP that he considers consistent with these priorities. The form of this plan will depend on what his priorities are. For example, an allocation plan related to the preceding statement of priorities might read like this:

Investment owned by Americans, which has been running at about 14 percent of GNP, should be restored to close to the 1973 level of 20 percent of GNP. Real defense expenditures should increase by 3 percent a year, instead of being frozen as recent legislation implies. A study of national security experts concluded that this rate of increase is necessary for the adequate modernization of our forces. To improve the condition of the poor, we will increase the share of the national output going to their consumption by 10 percent during the next four years, from about 2 percent to about 2.2 percent. We will also devote another two-tenths of a percent of the GNP to education. To achieve all of this, we will hold constant for the next four years real per capita income of people who are not poor, and we will slow down the growth of national health expenditures so that their share of the GNP does not rise.

All of these numbers will reflect the president's judgments. They will reveal what he intends to do and will be the basis for a national debate about the desirability of the ends and the effectiveness of the means. I should emphasize that I do not expect this plan for the allocation of the national output to be legislated. I look upon it as an explanation for and discipline upon the specific appropriation and revenue proposals that are to be legislated.

Third, the president should submit a four-year program, including but not limited to a comprehensive budget plan, to implement the desired allocation of the national output. On the expenditure side the program would run at about the level of generality of the 20 major functional classifications presently in the budget. Revenue changes and regulations the president considers appropriate to the GNP allocation plan would also be included.

Here we encounter the fact that in many respects the relations between budget actions and the allocation of the GNP are not fully understood. We do not know, for example, whether increased expenditures for Medicare increase total health provision for the aged, substitute for expenditures the aged would have made anyway, or increase the incomes of physicians — or in what proportions they do any of the three. But some beliefs or hunches about such connections are implicit in budgets and programs already in place, and these beliefs should be brought out in the open. If those connections become an integral part of the way we think about the budget, incentives to learn more about them will strengthen. If the connections between an activity and its presumed effects are truly unknown and unknowable, the government probably should not be engaging in the activity in the first place.

Before he submits his four-year program, the president

should discuss it with the congressional leadership and try hard to reach maximum agreement on it. The four-year program, unlike the GNP plan, should be enacted. It could be modeled on the present congressional budget resolution, except that it would be a law, signed by the president. It also would contain aspects of the Gramm-Rudman-Hollings law, in that it would be a binding multi-year plan. But unlike Gramm-Rudman-Hollings, its deficit path would not be arbitrarily decided but deliberately chosen because of its desired effect on investment. Nor would the expenditure composition be arbitrarily decided but would instead reflect explicit priorities. The program, once enacted, would permit a point of order to be raised against legislative proposals that are inconsistent with it. It would also require the president to submit budgets consistent with the program, but he could also propose other budgets and so request amendment to the plan.

Fourth, the president should request and Congress should enact two-year appropriations bills. The president and Congress should also work together to revise the appropriation structure so that Congress no longer acts upon the 1,000 line items, many of them of trivial size, and the 5,000 items reflected in report language. Dealing with so many small items is a diversion from the major questions that require congressional attention.

Undoubtedly, neither the president nor Congress will like this proposal very much. It would require them to be more explicit about their aims, to argue about the connection between the ends they espouse and the means they propose, and to recognize the limits of what the economy can stand. It is an attempt to expose the whole process to information and analysis, which limits the ability of presidents and legislators to ignore or conceal what they are doing.

Despite the understandable resistance of presidents and lawmakers to ceding power and accepting discipline, there have been movements in my direction in the past 15 years. The Budget Reform Act, Gramm-Rudman-Hollings, the 1987 budget summit, the current consideration being given to two-year budgeting, all are steps toward thinking about the budget at a higher level of generality, accepting commitments for a longer term, and seeking more constructive relations between the president and Congress. These steps fall far short of our needs and contain too many arbitrary features. But they signal the possibility of change.

In any case, I do not think of the president and Congress as the leaders of budgetary reform. In the past budgetary reform has been initiated outside the regular political process. The contributions of the Taft Commission of 1911, the predecessors of Brookings in the early 1920s, the Committee for Economic Development and others in the early postwar period, and the commission on the definition of the budget come quickly to mind. Less inhibited by political considerations, private leaders can speak more freely. If private people who talk about the budget, and there are many of them, will talk about it in what I consider rational and functional, well-informed terms, politicians will have to adapt.

What the Budget Might Look Like

I have tried to distinguish clearly between my thoughts about how to make better decisions and my thoughts about what the decisions should be. I am proposing a way to think about the budget, not what to do about it. Even if my procedure were followed, the content of the budget would still depend on values that would have to emerge from the citizens and the politicians, who may not share my values, and from information that I do not have. To give a concrete illustration of what I am suggesting, however, I have produced some budgets that might emerge in the 1990s if my suggestions were followed.

My research assistant, Glenn Follette, and I first estimated how the GNP had been divided in the past 15 years

among investment, education, health care, provision for the poor, and consumption by the rest of the population. The official GNP figures published by the Department of Commerce are not broken down functionally. One cannot get from those figures a clean number for what is spent for health by governments, households, businesses, nonprofit institutions, for example. The same is true for education, for consumption by the poor, or for government capital expenditures. We estimated those things as well as we could, but it will be important for the Department of Commerce to develop accurate figures.

We then used the baseline budget prepared by the Congressional Budget Office (CBO) and some other information and assumptions to project how the GNP would be allocated in 1993 if the baseline budget were followed.

Use	1973	1980	1986
Defense	5.7%	5.2%	6.6%
Education	6.4	6.2	6.2
Health care	7.5	8.7	10.3
Consumption by the poor	1.6	2.0	1.9
Consumption by the nonpoor	53.4	53.6	54.7
Investment owned by Americans*	20.1	18.5	14.3
Other government spending	4.7	5.1	5.2
Government transfers and interest abroad	0.6	0.7	0.9
Total	100.0	100.0	100.0

Sources: All data except consumption by the poor from Bureau of Economic Analysis, Department of Commerce, *The National Income and Product Accounts of the United States, 1929-82* (GPO, 1986) and *Survey of Current Business* (July 1987). Consumption by the poor estimated by the author using U.S. Bureau of the Census, *Money Income and Poverty Status of Families and Persons in the U.S.: 1986* (GPO, 1987); *Characteristics of Households and Persons Receiving Selected Noncash Benefits: 1984* (GPO, 1986); and *The Budget of the United States Government* for fiscal years 1973, 1980, and 1986 (GPO, 1972, 1979, and 1985).

Use	Baseline	Case A	Case B	Case C
Defense	5.5%	6.4%	5.5%	4.5%
Education	6.4	6.5	6.4	6.7
Health care	12.5	11.2	11.2	12.7
Consumption by the poor	2.0	2.1	2.0	2.3
Consumption by the nonpoor	51.5	49.5	49.6	50.6
Investment owned by Americans*	16.8	19.0	20.2	18.0
Other government spending	4.5	4.5	4.5	4.5
Government transfers and interest abroad	0.8	0.8	0.8	0.8
Total**	100.0	100.0	100.0	100.0

Sources: Author's calculations based on Bureau of Economic Analysis, Department of Commerce, *The National Income and Product Accounts*.

Table 1. Recent Uses of the GNP
(percent distribution)

*Investment owned by Americans is gross private domestic investment plus federal, state, and local capital expenditures not included in other categories less net foreign capital inflow.

Table 2. Alternative Uses of the GNP in 1993
(percent distribution)

*Investment owned by Americans is gross private domestic investment plus federal, state, and local capital expenditures not included in other categories less net foreign capital inflow.

**Estimated total GNP in 1993 is \$6.5 trillion.

**Table 3. Possible Spending Cuts,
Revenue Increases**
(in billions of dollars)

Source	Estimated Effect in 1993
Raise premiums to cover 50% of cost of Medicare Supplementary Medical Insurance (SMI)	\$ 18.6
Establish new physicians' fee schedule under SMI	10.0
Increase Medicare deductible	3.6
Tax employer-paid health insurance as income	25.1
Eliminate agricultural income supports	15.0
Tax 60% of all Social Security benefits as income	11.3
Eliminate deductibility of state and local taxes	32.1
Limit the mortgage interest deduction to 15% of interest	14.5
Tax capital gains at death	5.8
Tax 30% of capital gains from home sales	7.5
Raise tax on distilled spirits by 20%; raise beer and wine tax to that level	4.8
Double the cigarette tax	3.0
Increase motor fuel tax by 12 cents a gallon	11.7
Lower amount of contributions to pension and profit-sharing funds that can be deducted	3.4
Reduce miscellaneous subsidies (to Export-Import Bank, Rural Electrification Administration, and others)	3.6
Total	\$170.0

Source: Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 1988.

(These projections were derived from the baseline budget published by CBO in February 1988. Subsequent revisions of the baseline budget would change these figures somewhat but would not affect the process of thinking being illustrated.) This exercise also involved a number of assumptions about the relations between policies and GNP outcomes that we could only make crudely but that would have to be the subject of study and argument if my proposal to budget the GNP were to be implemented. But I do not think that the knowledge we would attain about these relations would be below the standards of reliability that we regularly count on in managing our economic and social affairs.

What stands out from these estimates is that the share of the GNP going to investment owned by Americans has declined substantially, from 20 percent in 1973 to 14 percent in 1986 (see table 1). This decline was closely matched by an increase in the total share going to consumption and health care, and the largest share of that was for health. The defense share increased a little. Education and provision for the poor stayed about the same. It also appeared that the shift from investment to health care and consumption was greatly affected by public policy, although a decline in the private saving rate was also

important. The rise of the federal deficit relative to GNP was a factor in the decline of the investment share, and the decline of net taxes — taxes net of transfer payments — contributed to the rise of the consumption share.

The baseline budget projected out to 1993 would change this allocation in certain respects. The investment share would rise, as the ratio of deficit to GNP declines, but the share would not return to the 1973 level of 20.1 percent or even to the 1980 rate of 18.5 percent. The share devoted to health care would continue to rise. The defense share would decline, as real defense expenditures are kept constant in the baseline budget, and the share of miscellaneous government services would also decline. The share of consumption other than health would remain about constant.

What effects on the budget would result if it were decided to allocate the GNP in 1993 differently? To illustrate, I describe three possible sets of priorities.

The first case gives high priority to defense, raising real defense expenditures by 3 percent a year. It gives low priority to consumption by the nonpoor and to health care, freezing real per capita consumption of the nonpoor, other than health care, until 1993, and freezing the share of health care in the GNP. Most of the resources thus

released, after providing for defense, would go to investment, although education and assistance to the poor could be increased a bit. The investment share would increase significantly, but would not return to the 1973 or 1980 level.

The second case, which I suppose is more conventional, would accept the baseline projection of no real increase in defense, thus cutting its share of GNP. But it would aim to restore investment to its earlier, higher share. Health care and consumption by the nonpoor would be treated as they were in the first case.

The third case, which I pattern after some of the proposals Jesse Jackson made during the primaries, goes in a different direction. It freezes defense in nominal terms, substantially reducing its share of GNP, and cuts consumption by the nonpoor, or, more precisely, the rich. It increases expenditures for health, education, and assistance to the poor. It also increases somewhat the share of the GNP going to investment but less than in either the first or second case (*see table 2*).

In budget terms, the first and second cases are more difficult than the third to achieve, because they require more shifts from the distribution of output projected by CBO's baseline budget. In a nutshell, both the first and second cases require shifting a little more than 3 percent of GNP from health care and consumption by the nonpoor to defense and investment. Because of its emphasis on investment, the second case requires a federal budget surplus equal to 1.3 percent of GNP in 1993, compared with a deficit of 1.9 percent projected in the baseline budget. Even the first case, which also calls for greater defense spending, requires a surplus equal to 0.3 percent of GNP.

If we translate these percentages into 1993 dollars, the numbers look terribly forbidding. That is because we are not used to thinking about an economy whose GNP will probably be about \$6.5 trillion by then.

Basically, the first and second cases require that about \$200 billion of 1993 dollars be diverted from health care and consumption by the nonpoor to defense and investment. If we don't know how to increase private saving — and I don't think we do — this amount of money has to be raised from tax increases and expenditure cuts that do not impinge on the high-priority items, which are defense, education, provision for the poor, and federal investment. Two questions will be raised immediately — one economic, the other political.

The economic question is whether this amount of tax increase and revenue reduction could be achieved without seriously damaging incentive and efficiency. I believe that the answer is "yes," and I have tested that by drawing up a list of steps that would yield the \$200 billion with economic effects that are probably good rather than bad. The steps include taxing employer-paid health insurance as income, eliminating the deductibility of state and local taxes in the federal income tax, raising premiums to cover 50 percent of the cost of Medicare Supplementary Medical Insurance, eliminating agricultural price supports, increasing the

"Undoubtedly, neither the president nor Congress will like this proposal very much. It would require them to be more explicit about their aims, to argue about the connection between the ends they espouse and the means they propose, and to recognize the limits of what the economy can stand."

motor fuel tax, and similar items (*see table 3*). The point to recognize about the claims that taxes cannot be raised without adverse effects is that the tax code now contains many exclusions that are economically distorting.

Merely to list such items, however, is to draw the response that their enactment is politically impossible. The tax privileges and subsidies are there because someone wants them quite badly. As things stand, the chance of removing them is slight. But the point of this whole exercise is to change the way things stand and the way people look at them. Decisionmakers and the public must be made to confront their real choices.

Would you rather retain the last 3 percent of GNP that an already affluent and abundantly doctored and dosed majority of the American population consumes or devote that 3 percent to improving the national defense and future economic growth? That is a legitimate and debatable question. If the politicians and the people, having faced and debated such questions, give answers different from mine, I cannot complain. My purpose is not to answer such questions but to get them raised and discussed. Talking about them head-on is the only way we will learn to make good use of the enormous income the American economy generates.

Is This Any Way To Pick A President?

The 1988 election is history, and Washington's attention is now focused on George Bush and how he handles the first days and months of his presidency. Yet the memories linger of a disappointing, at times downright appalling, campaign season. Many complaints about the 1988 presidential selection system are familiar ones: the system discourages the best politicians from running; the nomination process is too long, too expensive, and dominated by unrepresentative activists in several small states; the conventions are contrived and meaningless; the debates are sterile and uninformative; and increasing numbers of citizens, unengaged by the candidates and their campaigns, choose not to exercise their right to vote.

But what bothered critics most about the recent round of picking a president was the general election campaign. Even by contemporary American standards, this campaign seemed especially negative, trivial, and disconnected from the most pressing problems facing the country. If the final outcome was consistent with the underlying conditions that shape presidential elections (peace and prosperity, a popular retiring president, an effective Republican majority in presidential contests), the way we arrived at that decision did little to enhance the respect for and legitimacy of the system or to prepare the public for the governing problems that lie ahead.

Some of the complaints that have been made about the nominating process in recent elections were at least partly off target in 1988. The field of candidates, for example, included several major officeholders, and it narrowed less rapidly than in previous years; campaign themes tailored to Iowa did not travel especially well; momentum failed to push a single candidacy far beyond its underlying political strength; and Bush and Michael Dukakis were reasonable choices of their parties on such traditional grounds as experience, ideology, financial resources, and organizational support. Nonetheless a fair amount of discontent about the process remains among both Democrats and Republicans.

Over the next months, the issue of how to improve the way we nominate and elect presidents will almost certainly be revisited, as it has been every four years. To help kick off that discussion, the editor of the *Brookings Review* and I invited several thoughtful observers of and participants in the process to respond to this question: what single aspect of the presidential election process did you find most disturbing in 1988 and how would you set about correcting it?

The responses that follow reveal consensus on neither the nature and severity of the problems nor on what, if anything, should be changed. Nelson Polsby is certainly correct in

arguing that the first task of would-be reformers is to sort out real problems and small problems from non-problems. The wide diversity of views among our contributors on that initial coding suggests the agenda for reform is far from settled. Yet, if the past is any guide, some adjustments seem certain. As Congress, the parties, the candidates, and the media mull over changes in rules and strategies for the next campaign, we hope they will consider the following observations and proposals.

— Thomas E. Mann, Director
Governmental Studies, Brookings

Nelson W. Polsby — *Sort Out the Problems*

Americans complain so much about so many aspects of their elections that casual observers can hardly sort out real problems from small problems from nonproblems. Readers should demand serious diagnosis, backed up by reasons, before they endorse any remedies — including the ones offered here. For what it's worth, after 30 years or so of thinking about these issues (my first scholarly article on elections was published in 1960), here is a short laundry list of:

Nonproblems. The electoral college. It keeps splinter parties from wrecking the presidential election.

The amount of money spent on

elections. This spending is justified by the number and complexity of choices made in American elections, by the inattentiveness of voters to politics.

The amount of time spent on campaigns. America is the home of the long ballot and the loosely organized party. That means it takes time to organize our nominations more or less from scratch for every election.

Checks and balances, with the presidency and Congress dominated by different parties. It says here in the Constitution that checks and balances are supposed to cooperate in governing, to ensure the consent of the governed to national policy. If we vote for Republicans for president and Democrats for Congress, that's what we want.

Small Problems. Low voter turnout. This problem is fixable to a considerable degree by making registration easier. Election outcomes probably wouldn't change much if voting turnout were increased by, say, 10 percent, but that's no reason not to do it.

Stupid and uninformative presidential debates. These are probably fixable by adopting formats requiring some spontaneity from the candidates. Candidates, being extremely risk-averse, would, of course, not participate under such circumstances.

Real Problems. The majority party (the Democrats) has organized the presidential nomination process so that Republicans elect presidents without first having to become the majority party. It is, over the long run, unhealthy to put the political system so deeply in hock to minority interests. The Democrats should pull up their socks and deregulate their delegate selection procedures so that state parties and their leaders have more influence and real deliberation takes place. The Republicans should meanwhile expand their appeal to broader segments of society. If they were to succeed, they would deserve the presidential victories the Democrats are now handing them.

The draconian and silly restrictions on political contributions and expenditures that accompany provision for the public finance of elections. Public finance should promote politi-

cal competition by providing a floor, not a ceiling, on political money. The present regulations violate common sense, human nature (i.e., human ingenuity in finding loopholes), the law of diminishing returns, and, in my opinion, the First Amendment.

I don't expect anybody to take these views at face value; they require evidence and careful exposition. So do contrary opinions, no matter how often readers may have heard them repeated.

David E. Price —

Strengthen the Party's Role

The 1988 presidential election disturbed me in numerous ways, and many of the remedies — leadership by candidates, the engagement of critical issues, the observance of basic ethical standards — go far beyond what some disparagingly call “tinkering” with the nomination rules. Yet in the realm of process much was disturbing as well, and changes are needed to safeguard against more serious difficulties in the future. I will concentrate on the composition of the convention and the timing of the nomination process.

The bargain on party rules struck by Michael Dukakis and Jesse Jackson at the Democratic convention represented a familiar pattern of candidates pursuing their short-term interests at the expense of the party's longer-term good. The agreement also reflected views common in reform circles that delegates mainly represent candidates (as opposed to ongoing party organizations) and that a convention's legitimacy depends on its reflecting as precisely as possible the earlier outcome of state primaries and caucuses. Hence the move toward pure proportional representation in the allocation of delegates to candidates. And hence the drastic reduction in the number of party and elected officials permitted to come to the 1992 convention as unpledged delegates.

The party's 1981–82 Commission on Presidential Nomination established unpledged delegate slots (misleadingly dubbed “superdelegates” by those hostile to the proposal) to which each state



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*Rep. David E. Price, a Democrat from North Carolina, is a political scientist and author of *Bringing Back the Parties* (1984). He was staff director of the Commission on Presidential Nomination, better known as the Hunt Commission.*



A. James Reichley, a Brookings senior fellow, is currently working on a book on political parties. (Photo by Roslin Arington)

could name key party and public officials. The purpose was to tie elected officials more closely to the party, to give party deliberations a more "mainstream" character, and to give the convention more flexibility and a strengthened decisionmaking capacity. The next rules-writing body, the "Fairness Commission" (1985), increased the number of unpledged delegates somewhat by giving Democratic National Committee (DNC) members automatic seats, but in the process removed the discretion state parties had to name key officials of their own choosing — a bad bargain, in my view. Now the Dukakis-Jackson agreement has given us the worst of both worlds, eliminating the DNC slots but giving state parties no discretion, limiting unpledged seats to state chairs and vice-chairs, governors, and some members of Congress. It is a highly undesirable change, and it should be reversed.

Some semblance of order also needs to be brought to the nomination calendar. The disadvantages of holding isolated early contests in Iowa and New Hampshire — distorting candidates' allocation of time and resources and, particularly for Democrats, their message — far outweigh the advantages. But Super Tuesday was an antidote of doubtful value. It required candidates to give more consideration to the South in allocating their time and crafting their message, a positive change but one that did little to influence the 1988 outcome. Indeed, the main effect of Super Tuesday was to narrow the fragmented candidate field to Jackson and Dukakis, hardly the sort of outcome its architects had in mind. And after Super Tuesday, the South had no further opportunity to influence the process.

The main threat of Super Tuesday, however, is to the overall pacing of the nomination process. States representing 58 percent of the Democratic and Republican delegates had already held their primaries or first-stage caucuses by March 31, 1988. States scheduling primaries late in the season now must ask themselves whether they are forfeiting all influence on the outcome. The rush to the front of the calendar

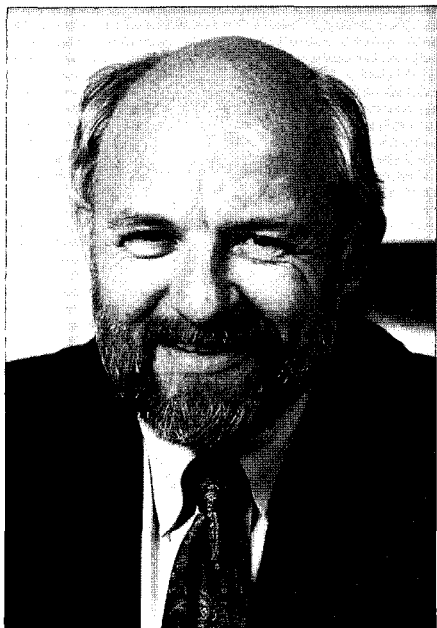
threatens the sequential, state-by-state character of the nomination system.

If we continue to move toward a de facto national primary, the real thing may not be far behind — a one-shot, media-dominated, big-money event that would be the death blow to state parties and the national convention — the complete antithesis of what a nomination process should be. I have been reluctant to advocate federal regulation of party affairs. Yet this may be one area where legislation is needed to enforce a spread and balance of nomination contests over a three-month period. For it is clear that the self-interested initiatives of individual state parties, legislatures, and candidate organizations have produced a deeply flawed system that is in danger of collapse.

A. James Reichley — *Elect the Nominators*

The presidential selection process actually performed reasonably well in 1988. Both parties nominated candidates who would make plausible presidents and who represented their parties' central ideological thrusts. The general election campaign, though it avoided the major issue of the federal budget deficit, gave the voters clear impressions of the differences in personality and character between the two major candidates and of the substantive differences between the parties. The media did a better job than usual of informing the voters what really was at stake in the election.

The most serious correctable problem in the selection process remains the way the two major parties now choose their nominees for president. The current system, which gives the power of choice almost entirely to a series of state primaries and caucuses stretching over more than four months, is much too long and costs too much money. The disproportionate influence given to Iowa, New Hampshire, and other states that participate early in the process is an affront to democratic values. And by boring, even disgusting, voters, the nominating process probably contributes to low



Edward J. Rollins, deputy director of the National Republican Congressional Committee, was assistant to President Reagan for political affairs and the national director of Reagan's 1984 campaign. (Photo by Lisa Berg)

turnout in the general election, another serious problem in the system.

Worst of all, because of the time and effort it requires of candidates, the present process either discourages highly qualified potential aspirants who hold important jobs other than president or vice president from running or places a heavy handicap on those who do run. Governor Cuomo is an example of the former; Senator Dole of the latter. Governor Dukakis dealt with the problem by turning over many of his state responsibilities to subordinates, with predictably bad effects on Massachusetts government.

Probably the best remedy would be to return to the system that had evolved before 1968, giving the primaries some role in testing candidates but leaving the final decisions to the national party conventions. I take it to be a rule of our political culture, however, that we cannot move back from what appears to be a more democratic system to one that appears less so.

Complicated schemes, such as holding regional primaries or scheduling all primaries on four successive Tuesdays, would not correct the unfair advantage given to whichever states go first and would sacrifice whatever value there is in having candidates campaign intensively in particular states.

Some political scientists propose holding conventions of party leaders, including many members of Congress, *before* the primaries, to weed out candidates who do not represent the mainstream of the party's elected officeholders. This approach would further complicate the process and might well dangerously shift the balance of power in the federal system toward Congress.

A national primary that would actually nominate candidates is the favored solution among democratic purists. But the winner in most cases would be nominated with only a plurality of the vote, not a majority (unless there were a runoff, which has problems of its own). A national nominating primary also would complete the destruction of the parties, and exclude little-known candidates (which might have some advantages — no more Jimmy Carters or George

McGoverns! — but again would unduly limit voters' choices).

Very reluctantly, I have concluded that the best achievable solution is a one-day national primary for the election of delegates to subsequent conventions at which candidates would actually be nominated. When there is a clear favorite, as Ronald Reagan was in 1980, the primary itself would effectively choose the nominee. But in most years, including 1988, the choice would probably go to the national convention.

This solution should have the good effects of shortening the campaign, strengthening the parties, and offering a wider choice of qualified candidates. It might have the bad effect of making campaigns even more costly, but my hope would be that truly national campaigns would become so prohibitively expensive that most candidates would concentrate on a few states. A candidate who raised an enormous war chest to finance a national campaign on television might find himself overwhelmed at the convention by a combination of state and regional favorite sons.

This solution has some downside — for instance, it would probably give even greater importance to television — but it should produce a clear improvement over what we have now.

Edward J. Rollins — Make Primaries Competitive

The Constitution's framers left a void when it comes to nominating candidates for the presidency. The system that has grown in that void gives too much power to a minority of voters in a few states and unfairly favors front-runners.

A new rule of politics is that candidates need to run several times to win a nomination. John Kennedy and Jimmy Carter are obvious exceptions, but George Bush and Ronald Reagan each campaigned more than a decade before surviving the primaries. One consequence is that good candidates in both parties start out with little chance of prevailing.

If you think that's good, read no

further. But if you believe the primaries should be more competitive, here are five steps toward reform.

1. *Hold five primaries.* To make the primaries more representative, we should have a series of five, each combining 10 large and small states regionally dispersed and held a month apart. The order should rotate every four years so that no set of states comes to dominate the process as Iowa and New Hampshire do now. Broadening the base will eliminate regional distortions, reduce the media-driven impact of early momentum, and give more voters a say in nominations.

2. *Raise spending limits.* The cost of campaigning has risen steeply since the 1974 campaign reforms were introduced. Media costs three or four times what it did in 1976. Cable television and VCR use means candidates will need even more media buys to get their message across in 1992. Sophistication of campaign technology also escalates costs. Ceilings on primary spending need to be raised and indexed to a political inflation rate.

3. *Raise contribution caps.* Candidates spend too much time raising money now. This is one area where we need less work and more pay. When a candidate like Richard Gephardt says that instead of spending 100 days campaigning in Iowa, he should have spent 90 raising money and 10 campaigning, it's clear we need reform. In 1974 the \$1,000 limit on individual contributions bought more and cost less to raise; now it buys less and costs more.

4. *Shorten the process.* By reducing the amount of time a candidate needs to spend raising money and expanding the number of early states in the primaries, we can afford to reduce the political season. The best way to accomplish that is to prohibit candidates from raising funds for the primaries more than a year in advance. By shortening the season, we may alleviate voter boredom, inject a greater sense of excitement, and thereby increase turnout.

5. *Have the parties sponsor debates.* Before each of the five primaries, the parties should sponsor debates that



Ann F. Lewis, former political director of the Democratic National Committee, is currently a fellow at the Institute of Politics at Harvard's Kennedy School of Government. (Photo by Ann Burrola)

emphasize educational rather than entertainment value. Instead of formats that allow one-minute questions and two-minute answers with little give-and-take, these debates should last two or even three hours. That will place a premium on depth rather than sound bites. Likely primary voters — those who are interested in the process — will watch.

The obstacles to reform are the nominees themselves. They tend to have the most influence but obviously little interest in changing a system that worked for them. Yet reform is necessary to revitalize the process and involve more voters in choosing nominees.

*Ann F. Lewis —
Communicate Commitment*

What most disturbed me about the 1988 election was the extent to which patriotic symbols can still be used by Republican candidates for partisan purposes — not as the result of some sinister right-wing plot, but because of the failure of my party throughout the past decade to communicate effectively to the electorate our own patriotism and commitment to American values.

It is tempting to ascribe this problem solely to Michael Dukakis and/or his Massachusetts experience. And it is certainly true that better strategies could and should have been used. The implicit question about the governor's veto of a state law requiring school children to recite the Pledge of Allegiance, for example, was not "Are you a lawyer?" but "Are you a patriot?" When Dukakis answered that question by proving that he was indeed a lawyer, he left unanswered doubts about his patriotism that had been so skillfully planted.

1988 may — I hope, will — turn out to be a particularly egregious example, but it is hardly the first time that Democratic candidates have suffered from a Patriotic Credibility Gap. As Democrats, it's time we stopped being surprised — or assuming that all we need to do is order still more American flags for the next national convention.

(I like the fact that Democratic conventions now feature lots of flags and bunting; and judging from recent post-convention polls, voters like it too. But those red, white, and blue images by themselves are not enough to overcome the negative campaign that is sure to follow. Forget the rhetoric about a kinder, gentler nation; does anyone reading this seriously anticipate kinder, gentler campaigns?)

If we Democrats expect to elect a president in this century, we have to assume that our candidates will be aggressively challenged on their patriotism and on their commitment to those values most important to most Americans, including the need for national security.

Democrats can meet this challenge, honestly and effectively, by making explicit now and for the next three years those values and principles that implicitly underlie the public policies we support.

I emphasize values and principles because that's where I think the gap occurs. Democrats take seriously the importance of governing; that's usually why we get into politics in the first place. We speak fondly and articulately of the details of governance, assuming that the public will understand our good intentions from the programs, policies, and specific legislation of which we are so justly proud.

But campaigns are not about governing; campaigns are about communicating. Our failure to communicate our ideals clearly in the past has left us vulnerable to charges that we do not understand, or share, the values on which governing must be built. Campaigns do not take place in a time warp; our ability to communicate effectively in the next presidential election cycle begins with the messages we send now.

Democratic principles built this country, leading the way in strengthening our families, homes, and communities. But voters are neither historians nor mind readers. If Democrats share their values, and we do, we should be proud to say so. If Democratic policies have made this nation stronger, and they have, we should be smart enough to say so.

David S. Broder —

What the Candidates Owe Us

The aspect of the presidential selection process I find most disturbing is the assumption by the managers of the two major party nominees that they should enjoy full and unchallenged control of the agenda, content, and format of the general election campaign for the two candidates. It is that assumption, I think, which underlies most of the excesses of the fall campaign. It must be challenged for there to be substantial improvement.

My belief is that the 10 weeks from Labor Day to Election Day are the one period each four years when the voters should be in control, should have their concerns addressed, their questions answered. The financing of the campaign is by the public. It was probably a mistake for Congress to direct that the public subsidy go to the candidate's committee, rather than to the party nominating him. In any case, these candidates are running on our money, and they owe us certain obligations in return.

They owe us debates. These should not be discretionary or subject to prolonged negotiation. Participation in at least three presidential debates and one vice presidential debate should be made a condition for acceptance of public financing.

Second, the candidates owe us a reasonable dialogue on issues of public concern. At the very least, that means substantive speeches on those questions that polls indicate are uppermost on voters' minds. It also means that the candidates make themselves available to the media, at least once a week, for at least an hour, to answer questions about their own policy positions and criticisms of them from their opponent and other individuals.

The dialogue would be further advanced if the commercial television networks could be encouraged (I would hope it would not take legal sanctions) to make 10- or 15-minute blocks of time available on their main evening news shows, once a week from Labor Day on, for questioning one of the candidates on one of the topics of greatest interest to the public.

And, finally, the candidates should have to take personal responsibility for the advertising they prepare and air with public funds. Either the candidate or the campaign chairman should be required to hold a news conference within 24 hours of the introduction of any new ad, to supply backup evidence for statements made in the ad, to answer questions about it, and to justify the use of taxpayer money for this kind of message.

Juan Williams —

Report the Substance

The single most distressing development in the presidential campaign was the political professionals' success at handling the press. This was no adversarial relationship. It was a dominant-submissive one — a relationship that made the neighbors want to call the police.

In 1988 the campaign managers perfected the art of isolating their candidates from the press, letting them out only for a single good sound bite. That tactic ensured that reporters covered only what the campaign managers wanted on the air or in the paper on any given day. The managers also refined the use of the perfect picture — reducing the candidates' campaign appearances to little more than staged shows. Even when these set pieces had nothing to do with substantive issues, TV news producers found them irresistible and used them anyway.

While newspaper editors and TV producers realized what was happening to them, they had no idea how to respond effectively. Eventually they started covering the manipulators. "Spin doctors," "handlers," and "visuals" became part of the campaign story. The public was let in on the secret of how the news media were being robbed of their rightful role as observers and critics of presidential candidates and campaigns. But the media coverage of the manipulators was no match for the daily onslaught by the manipulators.

The key reporters were the TV critics, and the most important analyses were their reviews of the "free" TV



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Juan Williams is a reporter with The Washington Post and author of Eyes on the Prize: America's Civil Rights Years, 1954-1965. (Photo by Diana Walker)

time — the prepackaged daily statements, appearances, and endorsements crafted for television — and “paid” TV time — the prepackaged commercials, the best of which were negative advertisements aimed at hurting the other guy.

In this bizarre substitute for a campaign, the candidates mattered as little as the reporters. Their biggest job was to avoid saying or doing anything that might blemish the packaged media image the professionals were selling the voters.

Absent from the campaigns was any serious discussion of the real issues. Only occasionally did reporters do stories about the segregation of black voters; the infantile level of the campaign rhetoric on important tax and budget policy; the rising cost and declining quality of education; the contract scandals at the Defense Department. But, gee, those stories were boring compared with the gossip and the punch-and-counterpunch offered by the media advisers as they prettied up their candidate's image and threw mud on the opposition.

The corrective for the problem is twofold. First, a more confident press will have to decide that it is not being unfair to the candidates if it sets an agenda different from the one the candidates are pursuing. If a paper, magazine, or TV network sees a critical problem — with housing, the budget, race relations — it must feel free to write and talk about it, making an issue of the problem because the candidates will never do so. And the press is unfair to the public if it fails to point out when the candidates evade or lie about these critical issues.

The second part of the corrective is to adopt a government standard for political advertising. Paid commercials should be restricted to appearances by the candidates, who would be permitted to talk and only to talk. No beautiful scenes. No makeup. No cheering crowds. No chubby-cheeked children. No horrifying visuals of where the opponent's policies will lead. Simply let the candidates give their message to the voters on any subject. Let the voters see the candidates. If that is done, there will be a natural return to issue-

oriented debate and political argument — the essentials of democracy.

Steven I. Hofman —
Hold Them Accountable

Just after the 1988 Republican convention, a reporter called to ask whether I had done a budgetary analysis of the Republican platform. His call was not without reason; several weeks before, the Republican Research Committee, which I then directed, had released a similar study of the Democratic platform. My reaction, however, struck this reporter as unhelpful; “That's your job, not mine,” I said. In the end, the reporter didn't write the story.

Reflecting on this incident, I suspect there were two reasons why no story appeared. First, the reporter's decision mirrored a growing tendency in the press to avoid issues in a presidential campaign that are complex and require extensive background research. Campaign news only becomes news today if it can be shaped into 20-second sound bites, particularly if the press is handed a ready-to-go product. Second, the Democrats who would otherwise have delighted in shooting holes in the Republican platform, didn't prepare an analysis of it; they understood better than I how the press operates. It is this incident and its implications for future campaigns that disturbed me most about the 1988 presidential campaign.

Behind my concern is a belief, shared by others, that the press is abdicating its crucial role in modern presidential campaigns. The party platform example is instructive here as well. Both parties used their platforms for tactical purposes during the campaign. The Democrats wrote a brief, vaguely worded document to help change their image from a party of special interests to a party of tough-minded fiscal managers. Planks endorsing new federal programs, to take one example, were “no-nos” in the new and different Democratic party. In contrast, the Republicans were thinking “kinder, gentler.” Their platform contained proposals for child care, prenatal care, and early education, to name a few. Root-canal Republicanism



Steven I. Hofman, currently a guest scholar at Brookings, was director of research and policy for the House Republican leadership. (Photo by Roslin Arington)

was banished from this new and different Republican party.

A passive and uncritical press was a key ingredient both parties needed to change their image without necessarily changing their ways. The Democrats had a congressional agenda in 1988 (long-term health care, \$5 billion; housing, \$2 billion; and child care, \$2.5 billion, among many others) that was anything but fiscally restrained. For their part, the Republicans were anything but kinder and gentler to domestic programs during the Reagan years. If one of the roles of the fourth estate during a presidential campaign is to force the candidates to justify inconsistencies and changed positions, then I would observe that both campaigns were politically, although not ethically, correct in choosing tactics that assumed the press would fail in this task.

Recently *The Washington Post* ran the following headline: "Carter, Ford Say Media Too Enamored of the Quick and Easy Story." Clearly I'm not alone in my observations. President Ford's remarks were directed at the way journalists cover the politics of the budget deficit. My comments are based on observing a narrow slice of the presidential campaign. But whether the problem relates to the day-to-day coverage of policy or the go-go atmosphere of a national campaign, the implications are equally troubling. The American people become less informed, more cynical, and less involved in our political process. Moreover, even the press understands these concerns. As ABC News correspondent Richard Threlkeld recently told *Washington Post* correspondent David Broder: "I don't know what the hell we get paid for if we don't make an effort . . . to keep those guys honest. If we don't, who will?"

There is no silver bullet solution to this problem because blame is not limited to the press. Sure, the press should be a more effective watchdog, but even the best watchdog can't see everything. Nonetheless, let me offer one suggestion that could force future candidates and parties to begin to fear the wrath of the American voter when they seek political gain at the cost of

veracity. The press should never report on what a candidate promises without including the context and implications of what is said. To most readers of the Review, this suggestion no doubt sounds conventional and self-evident. Let me assure you, in practice it is not.

Michael Nelson —
Pay Attention to Turnout

Political scientists are well practiced at telling people that political institutions and processes that seem bad are really good (the seniority system in Congress, the electoral college) and that phenomena that seem good (ethics regulations, campaign finance laws) are really bad. Indeed, puncturing the conventional wisdom may be the most valuable service we perform for the larger political community.

For many years political scientists punctured much of the conventional wisdom that low voter turnout is bad. To those alarmed at low U.S. turnout rates compared with those of other, mainly West European, democratic countries, we offered solid explanations: the United States had stricter registration requirements, lower educational levels, more frequent elections, consensual political parties, and so on. Above all, political scientists encouraged the view that nonvoting in the United States reflected a general contentment among nonvoters—a mark of health, not pathology, in the American political system.

However well these explanations may account for the low level of voter turnout in U.S. elections when viewed in *comparative* perspective, they say nothing about why turnout in the United States has declined when viewed *historically*, especially during the past 30 years. In 1960 about two-thirds of the voting-age population participated in the presidential election; in 1988 exactly half did. In 1958 more than half the voters turned out for the midterm congressional elections; in 1986 less than a third did. With minor exceptions the decline in voting has been relentless: almost every election has had a turnout rate



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lower than the last.

This historical decline has occurred despite several developments that, according to the insights of political science, should have led to greater voter turnout. Registration is much easier now than it was in 1960, legal and other coercive barriers to black and Hispanic participation have fallen, education levels are higher, and media coverage of the campaign is more accessible. What needs to be explained is not only why turnout is declining but why it isn't rising.

Having dismissed concerns about low turnout as misguided conventional wisdom some years ago, political scientists, I think, can make only two definite statements about the causes of the decline: that they are political (not demographic) and that they are not peculiar to the alleged deficiencies of the 1988 campaign (the decline is too long-standing for that). "Further research is needed" is a hackneyed phrase, but, well, further research is needed.

As to the consequences of a shrinking electorate, political scientists have more to say, albeit indirectly. The discipline cannot predict precisely what will happen if, say, in 2004, the turnout rate is 40 percent. But we are aware of the importance both of legitimacy to democratic governments — the right to rule that the people accord them — and of the centrality of elections to legitimacy. We also know something (as did the ancient Greeks) about the empowering value that political participation has for citizens. And most of what we know suggests that, this time, the conventional wisdom is right — the continuing falloff in turnout is very disturbing.

Larry M. Bartels — Don't Ignore History

Candidates, voters, and party rule-writers all made plenty of mistakes in the 1988 campaign, but at least they will have to live with the fruits of their errors. The only people who go on happily, never having to acknowledge, suffer for, or desist from their wrong-headedness, are journalists, colum-

nists, and political experts. During the last campaign they demonstrated yet again that those who forget history are doomed to repeat it. Herewith a few examples.

The Brokered Convention. At every opportunity columnists looking for a new twist dredge up the old prospect of a draft or a brokered convention. In 1975 Donald Matthews found that four of every five references to the 1976 Democratic nomination in the *New York Times* and *Washington Post* involved draft or brokered convention scenarios; only one in five involved any of the active candidates winning the nomination. In 1987 and early 1988 the pundits rehashed the same script, with Mario Cuomo as Hubert Humphrey, Jesse Jackson as George Wallace (!), and (it turned out) Mike Dukakis as Jimmy Carter. The brokered convention scenario persisted into mid-March. Eventually even David Broder wavered; he should have stuck with his position of April 1987: "Forget it. It doesn't happen."

The Caucus Surprise. Sometimes forgetting occurs even within the course of a single campaign season. After Pat Robertson surprised the experts in the Iowa caucuses, they built up his chances in the New Hampshire primary, only to see him fizzle. Nobody noticed that he turned out more Republican voters in New Hampshire than he had in Iowa. His problem was that in a primary setting his mainstream opponents could turn out a lot more. Six weeks later Jesse Jackson surprised the experts in the Michigan caucuses. Guess who became the immediate favorite in the next round of primaries?

The Trial Heats. Whenever a candidate's name is recognized by half the public, he becomes eligible to participate in "trial heats" against prospective nominees of the other party. These trial heats sometimes provide clues to the relative electability of the various candidates within each party, but as forecasts of the November outcome they are woefully inaccurate. In 1988 Mervyn Field carried pre-convention trial heats to new heights, using an agglomeration of individual state polls to project an electoral col-

lege landslide for Michael Dukakis! Anyone who has studied the outcomes of presidential elections over the last 40 years should have known that was never in the cards. Most of the political scientists' numerous statistical models (based primarily on economic conditions) gave Bush a comfortable margin, as did the electorate in November. But Field gave Dukakis his landslide, and the pundits made not a whisper.

Prognosticators are not supposed to be perfect, and the lessons of history will sometimes turn out to be misleading. But the pundits' chronic neglect of those lessons is more misleading. It misleads the public not only about what will happen next week, but also about how the American electoral process works every week of every election year.

Stephen Hess —

Is Change the Solution?

Approximately 1,350 days before the 1992 Democratic convention Jesse Jackson is addressing a group of Iowa farmers. Must the race for president be perpetual, a grinding ordeal for candidates, journalists, and voters? Then there's the cost in dollars, and the loopholes that have let the political action committees and the fat cats back into positions of power. Add to the list the manufactured excitement of those summer nominating conventions long after we know who the winners will be. And the often casual way a vice presidential candidate is picked. The banality of public discourse. TV debates that aren't debates. TV commercials that are 30-second distortions. The anachronistic electoral college and the possibility of "faithless electors."

If I had my druthers I'd repeal the 22nd Amendment — why discriminate against two-term presidents? — and also change the Constitution to allow foreign-born citizens to become president. I don't even like the date of election day. Why must we go to the polls when the weather in Anchorage, Fargo, and Minneapolis is dreadful? We're not a nation of masochists.

So much deserves to be changed. Yet change has characterized the presidential selection process since 1968. Six elections and not twice have we played by the same rules. Changes in Democratic party rules led to the proliferation of primaries. Congress changed the system of financing campaigns. State legislatures invented Super Tuesday and, four years later, Super-Super Tuesday. There has even been a counterreformation producing superdelegates.

Is change the solution or part of the problem?

Candidates trying to work within a system of constant change have turned to a new class of experts, the for-hire consultants, who have contributed to lowering the level of ethics in politics.

Journalists trying to explain politics in a system of constant change have been profoundly misinforming. Remember last year's theories of a brokered convention?

Nor have changes produced better candidates. But they did contribute to nominating George McGovern in 1972, who had no chance of winning the election, and to nominating Jimmy Carter in 1976, who won but proved to be an inadequate president.

I write not as a warning about "unanticipated consequences." Such concern would freeze all imperfect arrangements. But, after a period of rapid and confusing change, it is time — in political scientist James Ceaser's words — for "a reasonable degree of stability."

Now is an ideal time to instill some stability into the system. In 1992 the Republicans can be expected to renominate a sitting president. Tinkering is not in their interests. The Democrats have been the instigators of past changes that, ironically, have repeatedly worked to their disadvantage. In 1992 they should want all the harmony they can get. The bloodletting that accompanies change will not be in their interests either.

So for the editor of *Review*, who requested a "provocative" proposal, here is my thought for improving the nomination and election process in the short term: Make no changes.



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Congress and Campaign Money

The Prospects for Reform

Candice J. Nelson and David B. Magleby

Even before the new Congress was elected on November 8th, candidates and commentators alike were discussing the need to reform the way House and Senate campaigns are financed. The quantities of money spent, the growing reliance on special-interest money, and the seeming invincibility of most incumbents led observers of all political persuasions to suggest that perhaps the time had come for the first revision of campaign finance law in more than a decade.

Almost every election brings calls for campaign finance reform. The issue was last debated at length in the Senate in 1987–88. But strong, unified opposition from Senate Republicans, coupled with a liking for the status quo among House Democrats and a wariness among House Republicans about how changes in the election laws might affect them, made passage of any reforms doubtful from the beginning.

This year, however, campaign finance is likely to become part of a broader debate in the 101st Congress about ethics. House Speaker Jim Wright and House Minority Leader Robert H. Michel have already appointed a bipartisan task force to review House ethics rules. Ethics concerns have moved to center stage in Congress in part because of

Speaker Wright's use of royalties from his book, *Reflections of a Public Man*, sold largely to lobbyists. Wright, who made \$55,000 in royalties from the book, had earned close to the legally permitted maximum in honoraria for speaking engagements. One Texas developer, who purchased \$6,000 worth of the book, was reported by the *New York Times* to have said, "I couldn't give him any money, there are rules against that. So I bought his book."

The royalties issue is closely tied to the question of honoraria, which many members of both chambers accept for speaking engagements. These honoraria often come from the same interest groups that contribute campaign funds to and lobby lawmakers on relevant legislative committees and in leadership positions. In 1987 senators received an average of \$31,800 and House members \$15,530 in honoraria. At the beginning of the 101st Congress, members agreed to ban honoraria in exchange for higher salaries; however, when public pressure forced a vote on the salary increase, both the raise and the honoraria ban were doomed.

The enormous quantities of "soft money" spent in the 1988 elections has also made presidential campaign finance reform an issue. George Bush and Michael Dukakis each were given \$46.1 million in public funds to spend on their general election campaigns. In addition, both sides spent an estimated total of \$100 million in soft money — contributions and expenditures that are not limited and need not be reported under federal law if they are spent on activities such as registration and get-out-the-vote drives.

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The assumption underlying public financing of the presidential campaigns is that the candidates will not raise and spend additional private money. The two political parties made a mockery of that assumption, however, by taking advantage of a loophole Congress created in 1979 to permit party-building activity. In and of themselves, such activities are laudable, stimulating greater citizen participation in the political process. But the 1979 amendments also allowed wealthy individuals to make undisclosed contributions to the parties well in excess of the federal contribution limits, thus undermining both the contribution and disclosure provisions of federal law.

It is possible that Congress might attempt to close the soft-money loophole without getting into questions about congressional campaign financing. But the high costs of campaigning, the lack of competition in the House, and the growing influence of political action committees all make it likely that campaign finance reform will be on the legislative agenda in this Congress.

The Money Chase

The high cost of running for office is one important justification for reform. In 1986 candidates spent \$450 million to run for Congress, a 500 percent increase over what they spent in 1974, just 12 years before. Spending by Senate nominees has gone up even more, 617 percent. Even after adjusting for inflation, spending by House candidates still more than doubled, and spending by Senate candidates rose 174 percent. Media advertising costs account for much of the increase.

Spending tends to surge more in midterm election years than in presidential election years, when attention and contributions are focused on the race for the White House. Given these patterns, spending is not likely to have increased as much in 1988 as it did in 1986. Moreover, in terms of real dollars, spending growth is slowing in both types of elections (see table 1). These facts, however, are little consolation to potential candidates thinking of

challenging an incumbent or running for an open seat. It cost an average of \$1,778,657 to challenge a Senate incumbent in 1986, and an average of \$420,979 to run for an open House seat (see table 2).

A comparatively few races in the House and Senate account for much of the spending jump above inflation. When we divided House and Senate races into deciles according to mean expenditures over time in real dollars, we found that the spending for all but the top 20 percent of races has remained fairly level since 1980. The dramatic spending increase has occurred most clearly in the most expensive 10 percent of races in the House and Senate. Spending in real dollars by House challengers has actually decreased since 1982, while spending by candidates for open seats has risen sharply in both houses. These statistics explain one important factor in the declining competitiveness of House races. Because House incumbents are able to raise and spend what they think is necessary to respond to perceived serious challengers, challengers are finding it harder and harder to raise enough money to be strong contenders.

The costs of seeking congressional office pose several problems that differ for House and Senate candidates and for candidates in competitive and noncompetitive races. Because virtually every Senate race has the potential to become competitive, senators must spend increasing amounts of time raising money. Senate candidates report being told by their campaign managers to plan to devote at least half their time to fund-raising. House candidates in competitive districts face similar demands. For example, Peter Hoagland, elected to the House of Representatives from Nebraska in one of the few open seats in 1988, spent over \$800,000, winning his seat by only 3,431 votes. And the more time candidates must spend fund-raising the less time they have for the more traditional aspects of campaigning, such as meeting potential voters. For incumbent senators, time spent fund-raising also means time spent away from the legislative process.

To raise large sums of money in the least amount of time, candidates turn to those able to contribute money in

Year	House		Senate	
	Democrat	Republican	Democrat	Republican
1980	\$325,552	\$420,091	\$1,763,382	\$1,548,368
1982	327,907	450,827	2,683,604	2,666,685
1984	470,908	466,295	4,975,608	4,760,290
1986	463,406	553,641	3,524,124	4,463,267

Note: Includes primary and general election expenditures by major party nominees in competitive elections only (net expenditures, where possible).

Source: Federal Election Commission.

Table 1. Real Average Expenditures in Competitive Elections, 1980–86
(in constant 1986 dollars)

Table 2. Average Campaign Expenditures, 1974–86

Year	House			Senate		
	Incumbent	Challenger	Open Seat	Incumbent	Challenger	Open Seat
1974	\$ 56,539	\$ 40,015	\$ 90,426	\$ 555,714	\$ 332,579	\$ 401,484
1976	79,398	50,795	124,506	649,801	433,263	756,951
1978	111,247	75,015	199,482	1,341,942	705,437	791,727
1980	164,259	99,884	208,058	1,314,098	844,668	1,118,616
1982	262,085	129,324	292,511	1,762,728	1,170,949	4,141,920
1984	279,044	127,012	352,606	2,484,714	1,040,425	4,465,641
1986	337,172	125,759	420,979	3,307,430	1,778,657	3,134,409

Note: Includes primary and general election expenditures (net, where possible) by major party nominees only.

Sources: Norman Ornstein, et al., *Vital Statistics on Congress, 1984–85 Edition*, American Enterprise Institute, 1984; Federal Election Commission.

the largest chunks allowable under current contribution limits — namely, individuals who can give a candidate the legal maximum of \$1,000 per election, or \$2,000 for the primary and general elections, and political action committees (PACs), which may contribute \$5,000 in each election, or \$10,000 altogether, to individual candidates (see table 3).

The number of individuals who can give the maximum is not large, nor are such individuals evenly dispersed across states and congressional districts. Many candidates find themselves appealing to individual and PAC contributors outside their states and districts. This “nationalization” of congressional campaigns suggests that candidates have two constituencies: their electoral constituency, those who voted for them within their state or district, and their financial constituency, the PACs and those individuals who contributed to them from outside their state or district. This development raises an important question of representation. To what extent are members of Congress beholden to their financial constituency, at the expense of their electoral constituency?

PAC Race

That question is particularly pertinent with regard to PACs, which now account for almost half of all funds raised by House Democratic incumbents and nearly two-fifths of the money raised by House Republican incumbents (see table 4).

Following passage of the Federal Election Campaign Act in 1972, the number of PACs grew — from slightly more than 600 at the end of 1974 to 4,000 in 1988 — and so did their role in congressional elections. The lower limits on individual contributions coupled with the mounting costs of running for Congress made PACs an attractive alternative source of funds, and they were more than

willing to contribute. PAC contributions to congressional candidates rose from \$12.5 million in 1974 to approximately \$146 million in 1988.

Moreover, many members of Congress who have no serious opposition still receive substantial amounts of money from PACs. In 1986, for example, Dan Rostenkowski, chairman of the House Ways and Means Committee, received \$212,883, or 87 percent of his total campaign receipts, from PACs, yet easily won re-election with 79 percent of the vote.

To many observers, including ourselves, campaign contributions give special interests a role in congressional decisionmaking that is disturbing. One need not argue that PAC money buys votes in order to posit that PACs have altered the way in which interest groups shape congressional behavior. No matter what they might say publicly, members of Congress are more inclined to listen to an organization that has contributed to their campaigns. On matters not directly affecting their constituents, the same members will think long and hard before voting against the interests of those PACs. In such cases money, at least as much as the quality of the argument, carries weight.

PAC money is interested money given to candidates the interest group thinks can help it or whose potential to do damage it wants to minimize. The patterns of PAC contributions are consistent with this assertion. PACs give to incumbents much more than to challengers, particularly to chairmen of relevant committees and subcommittees and to their members — banking PACs to the banking committees, oil company PACs to the energy committees, and so on. Many PACs also contribute to the leaders of the House and Senate.

Most members of Congress actively solicit PAC money. PAC directors are favored guests at fund-raising events;

indeed, the Washington fund-raiser, an opportunity for lobbyists to show their support for the lawmakers, has become a mainstay of the Monday-to-Thursday-evening social circuit in the nation's capital.

All PACs are not equal in resources. Many are small, contributing far less than the maximum allowed. These PACs exist only because they recognize that money plays a role in congressional elections and decisionmaking, and they want to be players. Only a minority of PACs have the resources to "max out" — contribute the maximum — to a candidate. Campaign contributions are only one way interest groups influence lawmakers. It would be naive to assume that reducing the amount of money PACs give to candidates will remove that influence in the electoral and legislative processes. Organized interests will and should, under any reform scenario, continue to provide political and policy information to legislators, mobilize their membership in support of or opposition to particular policies, and inform and educate the public. Their more direct role in financing elections is what is at issue.

The Safe House

As campaign costs go up, the advantages of incumbency become more and more apparent. In addition to being the largest beneficiaries of PAC contributions, incumbents can use the resources of their office — the franking privilege, their staffs, and opportunities for free media coverage — to stay in constant touch with their constituents. Matching these advantages has become next to impossible for all but a few well-known or wealthy challengers. The advantages of incumbency in congressional elections are especially obvious in the House of Representatives. Not only have virtually all House incumbents seeking re-election been successful during the last few election cycles, but also fewer and fewer find themselves in close races. In 1988, 85 percent of all successful House candidates won with 60 percent of the vote or more, ensuring a continuation of the lopsided Democratic-Republican split and moving the Democrats closer to becoming a "permanent majority" in the House (see table 5).

Congress as an institution has also been adversely affected by the way campaigns are financed. Fund-raising and campaigning starts earlier in the Senate and seems never to cease in the House. Republican Alfonse M. D'Amato of New York, for example, raised more than \$4 million during his first four years in the Senate, well before the more traditional two-year campaign season begins for U.S. senators. Early in a new Congress, members, especially newly elected ones, often hold fund-raisers to retire their debt from the previous campaign, only accentuating the reality that the money chase for Congress never ends. Senate leaders of both parties have complained of difficulty scheduling legislative business because members are out raising money, attending fund-raising events for colleagues, and the like. Leaders of both parties have also complained of the increased influence of interested money, especially PAC money, on legislation.



The Pop-Up Problem

Any effort to reform campaign finance rules must take two complicated problems into account. The first is whether the flow of money in campaigns can be regulated effectively. It is important to understand that holding down specific sources of money in campaigns often only means that money will pop up somewhere else, reaching the candidate or his cause through some unrestricted channel. Some argue that this fact makes any attempt to regulate money in politics hopeless. We disagree, but recognize the challenge.

The election legislation enacted in the 1970s amply demonstrates that revisions of the campaign finance rules have significant unintended consequences. One result of the 1972 law was the growth in the number and importance of PACs. Another was the use of bundling — that is, collecting campaign contributions from a number of individuals or PACs and presenting them in a package to a candidate. For example, in 1986 ALIGNPAC collected more than a quarter of a million dollars in contributions from individual insurance salesmen and presented them in a “bundle” to Senator Robert Packwood. The intended effect of such activity is to increase the credit the special interest group builds up with a member without exceeding the PAC contribution limit. The exemption from party spending limits of money spent on volunteers, registration drives, and get-out-the-vote activities created the opportunity for the substantial amounts of soft money spent in the 1988 presidential race.

The Supreme Court’s 1976 decision in *Buckley v. Valeo* also resulted in some imbalances that Congress had not contemplated. In that landmark decision, the court upheld contribution, but not spending, limits. It also ruled that Congress could not impose restrictions on the amount of personal resources a candidate spent or on independent expenditures — those made on behalf of a candidate but

without the candidate’s consultation or concurrence. The first exclusion increased the importance of personal wealth in considering whether to run for office. The second exclusion gave individuals and groups a constitutionally protected avenue to seek to influence congressional elections irrespective of any limits on direct contributions to campaigns. Permitting unlimited independent expenditures enables individuals and groups who have reached their legal limits in direct contributions to spend more money independently, so long as the candidate or the campaign organization is not involved in decisions about how the money is spent. Some PACs spend hundreds of thousands of dollars independently on targeted races; AMPAC, for example, the political action arm of the American Medical Association, spent \$1.5 million in 1986 to try to influence the outcome in just 14 Senate and House races.

Any attempt to limit spending by candidates, parties, or PACs that does not deal with independent expenditures will almost certainly mean a shift in contribution patterns. Individuals and PACs that now contribute directly to candidates probably would increase their independent expenditures in behalf of those candidates. This potential growth in independent expenditures is only one example of the need for reformers to anticipate the likely effects of their actions.

Sorting Out Competing Interests

The second factor complicating any reform effort is that while more legislators may be expressing greater interest in revising campaign financing laws, they are not necessarily interested in the same revisions. Reform is not neutral. Any reform proposal will affect candidates in different parties, different chambers, and different electoral situations in different ways. To be successful, reformers must take into

Table 3. Contribution Limits

Contributor	To candidate (each election)*	To national party committees (calendar year)	To any other committee (calendar year)	Total Limit (calendar year)
Individuals	\$1,000	\$20,000	\$5,000	\$25,000
PACs	5,000	15,000	5,000	None
Party committees**	5,000	No limit	5,000	None
All other groups	1,000	20,000	5,000	None

*Category includes contributions to a candidate’s campaign committee; an election is defined as a primary, a runoff, or a general election.

**Party committees may also make coordinated expenditures on behalf of candidates for such activities as polling, mailing, and media production. For House candidates, party committees may contribute \$10,000 in 1974 dollars, adjusted for inflation (\$23,050 in 1988); for Senate candidates and House candidates in at-large districts, the limit is 2 cents times the voting age population of the state, adjusted for inflation (between \$46,100 and \$938,688 in 1988) or \$200,000, whichever is larger.

account these different, often competing, motivations for seeking change.

Senate Democrats, for example, are tired of seemingly endless evenings spent fund-raising in Washington and other big money centers. They would like to find a constitutional way to impose limits on campaign spending. House Democrats are not as concerned about spending limits. They have much less trouble raising money than their Senate colleagues, and they need less money because it costs less to run for the House and because most Democratic incumbents rarely face serious competition. At the same time, House Democrats have been stung by charges of ethical misconduct on the part of some of their members, most notably Speaker Wright. Although they clearly benefit from the present campaign finance system, House Democrats nevertheless favor some sort of reform, if for no other reason than to improve their image.

House and Senate Republicans have more common interests than do their Democratic counterparts, reflecting the GOP's status as the minority party in both chambers. Tired of defending political action committees only to see PAC contributions flow disproportionately to Democrats, Republicans generally favor limits on the aggregate amount of money candidates can accept from PACs. Indeed, some Republicans would go so far as to bar candidates from accepting PAC contributions altogether. Most Republicans also favor raising, or even abolishing, limits on individual and party contributions to candidates, believing that GOP challengers need to raise and spend more money if the party is to improve its numbers in the House and gain control of the Senate. Republicans favor raising limits for individuals because they have more individuals contributing the maximum under current law, and they favor raising the party limits because they have excess money they would like to direct to candidates, but cannot because of present limits.

"... holding down specific sources of money in campaigns often only means that money will pop up somewhere else, reaching the candidate or his cause through some unrestricted channel. Some argue that this fact makes any attempt to regulate money in politics hopeless."

Table 4. PAC Contributions to House Candidates, 1978-88
(amounts in thousands of dollars; percent of total contributions received)

Year	Incumbents				Challengers				Open Seats			
	Democrats		Republicans		Democrats		Republicans		Democrats		Republicans	
1978	\$ 9,825	35%	\$ 4,605	26%	\$1,342	14%	\$2,950	19%	\$2,028	18%	\$2,101	22%
1980	16,025	37	8,514	30	1,917	17	5,436	21	1,538	22	2,413	29
1982	22,253	38	17,627	35	6,094	28	4,239	19	3,848	28	3,784	22
1984	37,541	47	19,197	38	4,698	30	6,076	20	2,566	25	3,437	33
1986	40,924	49	24,806	38	6,411	30	2,336	12	6,023	31	4,750	25
1988*	44,934	51	24,258	39	5,705	33	1,395	9	3,329	36	1,818	20

*Figures for 1988 are contributions reported to the Federal Election Commission through Oct. 19, 1988.

Source: Federal Election Commission

Points of Agreement

Despite their different perspectives, Democrats and Republicans, senators and representatives generally agree on some reforms. One is a ban on honoraria in exchange for higher salaries. Members, however, find it politically impossible to vote to raise their salaries. Many members and the House leadership of both parties favored a pay raise this year, but when it came to a vote, over two-thirds of the House and Senate turned it down. With the rejection of the pay raise, talk of banning honoraria ceased. A ban without an accompanying pay raise would have meant a pay cut for most members, and there was no support for salary reductions.

Clearly sensitive to charges that they are captives of the special interests, legislators also appear to agree that there should be further restriction on PAC contributions to candidates. Senate Minority Leader Robert Dole has proposed lowering the amount a candidate can accept from a

"Simply put, Democrats support spending limits; Republicans oppose them. Democrats see spending limits as a way to slow, if not stop, the escalating costs of congressional elections. Republicans think that the only way they can increase their numbers in Congress is to spend as much money as they can."

PAC from \$5,000 to \$1,000, and raising the amount an individual can contribute from \$1,000 to \$2,000.

At least two other reforms would probably gain majority support in both chambers and in both parties. The first would require disclosure of soft-money contributors. The large amounts of soft money in the 1988 presidential elections undermined one of the purposes of the law, namely, to remove the influence of wealthy individuals in federal elections. While proposals to set limits on soft-money contributions might fail, there does appear to be widespread support for extending disclosure requirements to these donations.

Not surprisingly, legislators also seem agreed on reducing the costs of reaching the voters. Paid advertising accounts for a sizable share of the increase in campaign costs; those candidates who use paid ads spend approximately 60 percent of their campaign budgets on the ads, ad space, and air time. Senator Mitch McConnell introduced legislation in the 100th Congress that would have established a rate for campaign advertising that could not be preempted, and his proposal seemed to have bipartisan support. While members of Congress may differ on the precise means to reduce advertising costs in campaigns, they generally agree that something should be done. In fact, Congress enacted limits on media spending in the 1972 act, but the Supreme Court struck down those limits in the *Buckley* decision.

Areas of Disagreement

Despite these points of agreement, other reform proposals generate as much, if not more, disagreement. The most heated debate occurs over spending limits. Simply put, Democrats support spending limits; Republicans oppose them. Democrats see spending limits as a way to slow, if not stop, the escalating costs of congressional elections. Republicans think that the only way they can increase their numbers in Congress is to spend as much money as they can. They view any effort to impose spending limits as "incumbent protection." Unless spending limits are set high enough to let challengers spend enough to make themselves known, the Republicans are probably right.

Under the *Buckley* decision, spending limits are constitutional only if they are tied to public financing. Democrats are divided over this issue. Some support public funding as a way to reduce both the amount of money candidates must raise themselves and the time they spend raising it. Others see public funding as a way to remove private money, particularly special-interest money, from congressional elections. Still others oppose public financing of congressional elections in principle, but recognize it may be the price for spending limits.

Republicans in the past generally opposed public funding of congressional elections. Recently, though, they have begun to consider the idea of using public funds as a base, or floor, to get campaigns off the ground, allowing candidates to raise additional private money. From a Republican perspective, a public funding floor makes a lot

of sense because it would increase the ability of Republican challengers to make competitive races. The problem most challengers have is in raising "seed" money. Once a candidate has demonstrated that he or she can raise money, it flows to the campaign much more easily. Thus, if qualified candidates were guaranteed enough public money to begin to mount strong races, more races would be competitive.

To establish public funding without spending limits, however, would be very difficult politically. Many members of Congress simply cannot justify public funding of congressional campaigns if candidates are still allowed to raise and spend unlimited amounts of private money. At the moment, though, it is doubtful that Republicans would accept spending limits as a condition of public funding.

The parties are also split over the question of raising contribution limits for individuals and political parties. The Republicans support both, while the Democrats oppose both. Again, Republicans say their competitive advantage would be increased if they could spend more party money; Democrats suspect they are right. Democrats also oppose higher contribution limits because the Republican party has more money, although the gap in party resources is narrowing. Ten years ago the Republican party had a 10-to-1 fund-raising advantage over Democrats; today, it is closer to 3-to-1. Similarly, Democrats fear that higher ceilings on individual contributions will add to the coffers of Republicans at a much greater rate than to their own.

While there is very little support for raising the ceilings on PAC contributions — most people think \$10,000 an election cycle is high enough, and most PACs don't max out anyway — a case can be made for increasing individual and party limits at least by the rate of inflation (only party spending on behalf of candidates, so-called coordinated expenditures, is currently adjusted for inflation). Inflation adjustments would put today's limits on individual giving at about \$2,200 for each election or \$4,400 for an election cycle. It is hard to argue that such an increase would give wealthy individuals too much influence in the political process.

Similarly, raising party contribution limits would give the party committees a greater role in congressional elections. Clearly an argument can be made for allowing political parties and individuals, rather than PACs, to provide the bulk of a candidate's campaign funds. Moreover, if a limit is set on PAC contributions, candidates who rely heavily on them — namely, House incumbents, particularly Democrats — will look elsewhere for funds. With higher ceilings, the parties would be better able to provide those funds.

Serious reform of the present system will also require an overhaul of the Federal Election Commission. Right now, the FEC is just what Congress wants. It collects campaign finance reports from candidates, PACs, and the political parties, but it rarely pursues alleged violations of campaign finance regulations during the campaign season. The weakness of the commission is evidenced by the length of time built into the factfinding and decisionmaking process

Table 5. Competition for House Seats, 1960–88

Winning Percentage	Number of Districts in		
	1960	1980	1988
Unopposed	54	27	57
75-99%	43	94	91
70-74	27	64	94
65-69	49	60	62
60-64	59	50	66
55-59	112	61	36
52-54	56	39	17
51 or less	35	40	12

Source: C. Everett Ladd, *The American Polity*, 3rd ed. (W. W. Norton, 1989), p. 452.

and the FEC's pattern of deadlock along partisan lines. If limits were to be placed on spending, if partial public financing were enacted, or if aggregate PAC limits were imposed, then the Commission would need real enforcement powers, a larger staff, and a different decisionmaking process.

A Tactical Dilemma

Ironically the success or failure of campaign finance reform may well rest with its strongest proponents. Those members of Congress who favor a comprehensive package, including spending limits, some public financing, and aggregate limits on PAC contributions, face the same partisan and House-Senate obstacles that they have in the past. Yet increased interest in reform and potential areas of agreement on what should be done suggest that some revision of federal campaign financing laws may well be enacted in the 101st Congress. Those revisions, however, could come as a series of incremental proposals. Such proposals often do not raise the partisan disagreements that more comprehensive reform packages do.

The dilemma reform advocates face will likely be whether or not to accept incremental reforms, which make the campaign finance system marginally better but do not significantly address issues such as the cost of campaigns, the growing financial dependence upon special interests, and the declining competitiveness of many campaigns. If those favoring more comprehensive legislation join in supporting piecemeal reforms, they run the risk of reducing the pressure on Congress to consider congressional campaign finance for the next several years, and therefore admit that their larger agenda is indefinitely postponed. But if they do not support these more modest reforms, they perpetuate the partisan and House-Senate stalemate that has characterized this issue for more than a decade.

The Latin American Quagmire

Beyond Debt and Democracy

Carol L. Graham

Democracy, loosely defined, means constitutional, elected government. By that measure, Latin America has made impressive strides. Presidential elections are slated for this year in Argentina, Bolivia, Brazil, Chile, El Salvador, Honduras, Panama, and Uruguay; for next year in Colombia, Costa Rica, Guatemala, and Peru. Voters in Mexico, Ecuador, and Venezuela went to the polls last year. Elections were even scheduled in Paraguay, where General Alfredo Stroessner, who had ruled the country for 34 years, was overthrown in February, and in Nicaragua, which is under pressure to open up its political process. These elections, for many countries the second round since military dictatorships of the 1960s and 1970s gave way to civilian rule, are a notable achievement.

Yet if democracy is defined more comprehensively to signify progress toward socio-economic equality through political participation, then it continues to elude Latin populations. Fledgling democracies have been unable to turn around three- and four-digit inflation, negative growth rates, massive debt burdens, and labor unrest; nations remain divided between haves and have-nots.

Today, as much as 50 percent of Latin America's population is "marginalized." Increasing masses of rural peasants and urban poor are neither productive contributors to mainstream economic activity nor beneficiaries of it.

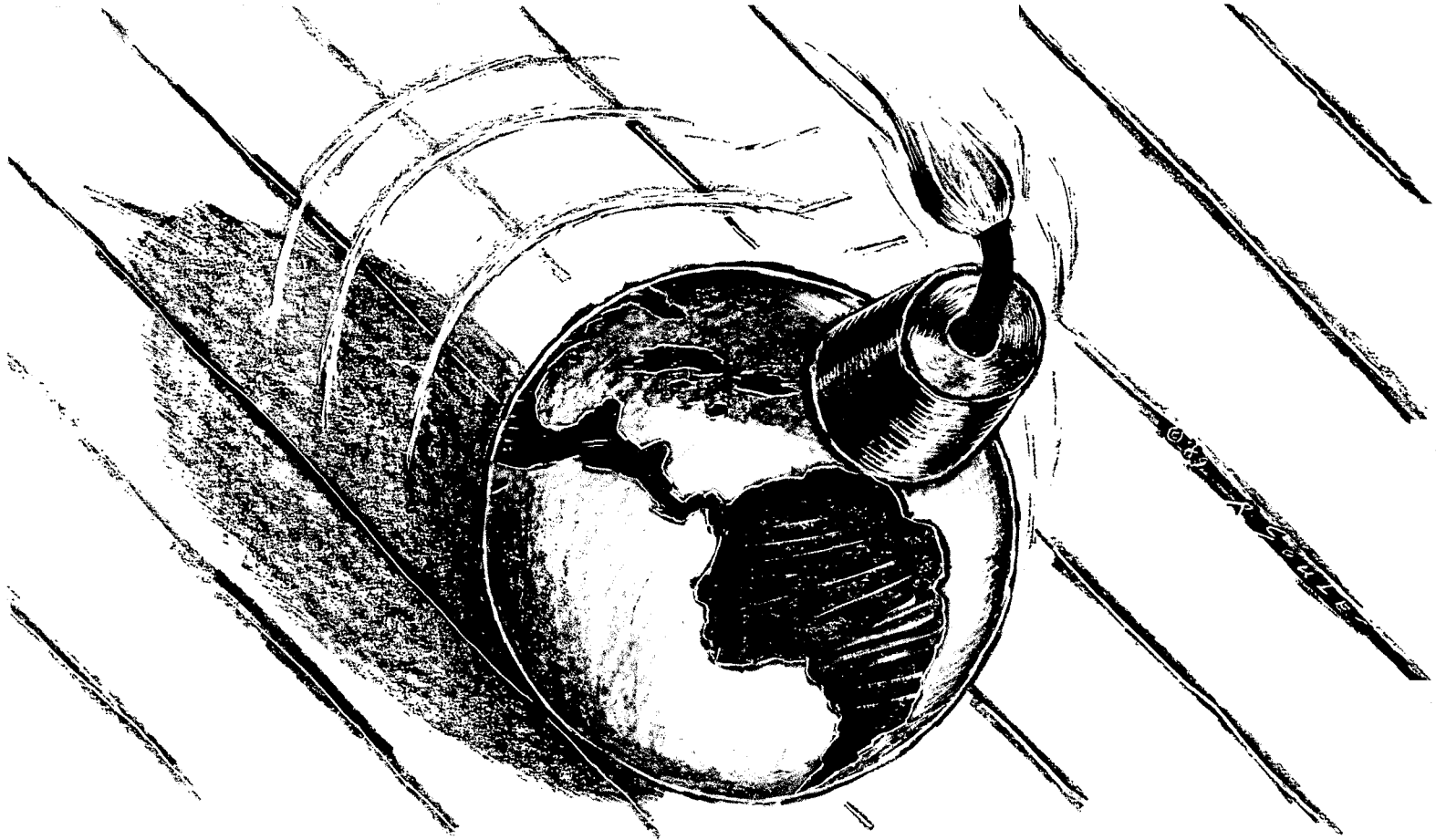
Growing numbers are also turning away in frustration from ineffective and inefficient formal political and legal institutions. As a result, informal economies are burgeoning, left-wing guerrilla and right-wing paramilitary groups are stepping up their activities, and powerful drug traffickers wield increasing influence.

Traditionally, Latin governments, dictatorial or constitutional, have been characterized by a high degree of centralized authority with weak links to the majority of the population. The new democratic regimes are no exception. Often they are out of touch with the realities of remote rural and urban slum populations, a distance that can be measured not only in miles but in education, culture, and income. As a result, Latin nations are split into societies versus states with each functioning virtually independently of the other. In this context, formal elections are of limited significance.

A Bleak Picture

Individual human rights and the degree of political participation have improved substantially since democratic governments began to take hold in the 1970s. Yet the fundamental economic and social problems that have beset Latin America for decades have worsened. Encumbered by unresponsive and inefficient state bureaucracies and enterprises inherited from the military regimes, the new democracies would have had considerable problems restructuring their economies in any event. World recession and the onset of the debt crisis made those problems all but

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intractable. Between 1982 and 1985 per capita income fell 14 percent, and the continent's share of world trade dropped from 6 percent in 1981 to 3.5 percent in 1985, statistics the region has been unable to overcome.

The foundations of the debt crisis were laid in the 1970s when military governments, free from the constraints of public accountability and spurred by optimistic forecasts for the prices of their commodity exports, borrowed expansively, usually at floating interest rates. Commercial banks, eager to recycle the surplus funds they had from OPEC petrodollars, were all too ready to lend. When interest rates skyrocketed in the late 1970s and early 1980s, and the world fell into recession, debt service payments soared, and the prices of Latin commodity exports dropped dramatically.

That combination, coupled with the burden of inefficient state enterprises, proved more than the Latin economies could bear. Although Costa Rica defaulted in 1981, the world was alerted to the Latin debt crisis in August 1982, when Mexico announced that it could not service its \$100 billion debt. Brazil and Argentina soon followed, as did several smaller nations. Despite dire predictions that the international financial community might collapse, coherent response was limited, and the debtor nations received most of the blame for the crisis.

Most prescriptions for recovery stressed export-led growth, but Latin debtors could not export themselves out of the crisis, when increasing commodity exports, especially during a world recession, could only lower prices. Latin exports increased in volume by 25 percent between

1981 and 1986, but their value remained the same and then declined with the drop in world oil prices. At the same time, continuing high interest rates pushed debt payments up in the early 1980s, and in the past two years, the depreciating dollar has in some instances increased the debt substantially, in Brazil's case by more than \$1 billion.

The impact of the debt crisis on Latin economies is difficult to exaggerate. In 1980 there was a net transfer of \$35 billion from rich nations to poor nations; in 1988 there was a net transfer in the other direction of \$30 billion. The interest burden falling on Latin debtors is now greater than that which the Germans in the Weimar era found intolerable. In 1929 the Germans owed interest equal to 3.5 percent of their GNP; in 1985 Brazil, Argentina, and Mexico paid an average of 6.6 percent of their GNP in interest. At the same time, four-fifths of Latin America's foreign exchange earnings come from primary commodities — petroleum, minerals, and agricultural goods — whose prices are likely to remain depressed for some time to come. In the absence of any new foreign capital, little relief is in sight.

The prolonged crisis has had visible manifestations on Latin economies. In the face of shrinking economic opportunities, increasing numbers have turned to informal or black market activities, as well as to criminal and insurrectionary violence. Well over half of Bolivia's export earnings are not officially acknowledged because they come from cocaine. Until Nicaragua surpassed it this year, Bolivia held the world record for inflation, which reached more than 11,000 percent in 1985. The country reduced that rate to 14.6 percent in 1987, but only by dismantling the

state-owned tin mining operations, resulting in a drastic increase in unemployment. Official figures reported one-fifth of the labor force to be underemployed or jobless.

Brazil has the largest debt in the developing world — \$116 billion — and is now rocked by an inflation rate of more than 1,500 percent and labor unrest in its large and dominant state-run industries. Growth in Argentina barely exceeded 1 percent in 1987, and the informal economy is estimated to be almost two-thirds the size of the official one. Since the onset of the debt crisis in Mexico, workers have lost as much as 50 percent of their purchasing power. Even stable Venezuela — where a decrease in oil revenues has contributed to a \$32 billion debt — broke its flawless repayment record early this year and declared a moratorium on principal payments. In neighboring Peru, economic collapse has raised the specter of coup or even civil war (*see box, p. 46*).

Exceptions to the Rule

There are two exceptions to the continent's norm of poor economic performance, but in neither case has success come without considerable costs. Colombia has one of the best economic records in Latin America: consistent growth rates, successful diversification from traditional primary product exports, and one of the lowest debt burdens. Prudent borrowing and good macroeconomic management are largely responsible. The influx of funds from cocaine exports, however, cannot be discounted as an economic stimulus. Using a combination of bribes and intimidation, drug traffickers have made a shambles of Colombia's judicial and police system. The country now has the highest murder rate in the world for a country not at war.

The most notable performance in the region is that of Chile under Augusto Pinochet. The government's record of coordinated macroeconomic policies, restructuring of the public sector, export-led growth, and punctual servicing and reduction of its debt is indeed remarkable. While some observers cite Chile as a model for other Latin nations, they discount the high price Chileans paid for economic success — real wage suppression, worsening income distribution, high unemployment, and curtailment of one of the most comprehensive social welfare systems in the region. Most important has been the loss, since 1973, of political and civil rights in a country that had maintained democratic government for 40 years.

Chileans are only now slowly returning to democracy. In an unprecedented plebiscite in October 1988, Pinochet put himself up for public approval and accepted, albeit hesitantly, his defeat. Pinochet does not give up power until March 1990, and he will remain head of the army, the most powerful branch of the armed forces. Under the 1980 constitution, the military will retain veto power over decisions on all matters of national security. The main opposition coalition, made up of 16 political parties, has agreed to unite behind a single presidential candidate for the December 1989 elections but is finding that unity

difficult to maintain during the selection process. Despite political rivalries, however, opposition leaders are committed to keeping Chile's economy on its current track.

Growing Radicalism

Throughout the rest of the continent, steady economic deterioration has led to growing political radicalism. At the far extreme, some, among them members of parliament in Peru and Colombia, actively support armed insurrection. More commonly, populist politicians are gaining in popularity. Highly nationalistic and often charismatic, these leaders make promises that appeal to the impoverished but fail to realistically address underlying economic problems. In many cases they are the very leaders and parties whose policies led to the social and economic chaos that ushered in the military regimes of the 1960s and 1970s.

Such a scenario might play itself out in Argentina, where Juan Perón led the quintessential Latin populist movement from 1946 to 1955 and again 20 years later. Perón's reliance on rapid wage increases and a vast expansion of the public sector contributed to inflationary chaos and military takeover. Since the fall of the last military regime in 1983, Argentina has been governed by Raúl Alfonsín and the Radical Party. Alfonsín's popularity has sagged as his government seems unable to cope with crippling economic problems and growing unrest. The nation in December experienced its third military revolt against the government in 18 months; in January and again in mid-February, left-wing guerrilla groups attacked army barracks.

The leading candidate to succeed Alfonsín in the May 1989 elections is Peronist Carlos Menem, who promises to impose a five-year moratorium on debt payments, raise real wages substantially, and increase prosperity for all. His only concrete proposal for funding that prosperity is to widen the tax base. Menem's election, particularly if his presidency is accompanied by the fascist-style tactics of the Perón years, would likely polarize Argentine society and deepen its economic crisis.

In Brazil the left made an impressive showing in the November 1988 municipal elections, benefiting from the increasing incoherence of President José Sarney's administration. The radical Workers' Party, led by trade union leader Lula da Silva, picked up 36 mayoralties, including key industrial centers, the port of Santos, and the southern capital of Porto Alegre. The Workers' Party platform, based on nationalism and a high degree of central planning, is rich with proposals such as mandatory price freezes that most socialist parties elsewhere have rejected as outdated. The more conservative governing party, the Brazilian Democratic Movement, failed to win a single state capital in the southern part of the country, its traditional stronghold. In 1986 the party had taken all but one of the nation's powerful state governorships. Meanwhile a key contender for the November 1989 presidential elections is the former mayor of Rio, the populist-socialist Leonel Brizola, who has been called Brazil's Perón.

Mexico's governing PRI (Institutional Revolutionary

Party), which has held power since 1929, nearly lost control in the July 1988 elections, where it was challenged both by a splinter coalition, the FDN (National Democratic Front), led by Cuauhtémoc Cárdenas, and by the right-wing National Action Party. A classic populist, Cárdenas promised to increase wages and threatened to impose a moratorium on debt payments — pledges that had far more popular appeal than did the PRI's calls for further reduction and increased efficiency in the bloated public sector. The FDN's campaign was strong enough to give credibility to charges that the PRI engaged in fraud to ensure the election of its candidate, Carlos Salinas de Gortari. The questionable legitimacy of the Salinas government and the broad support for the FDN's populist platform bodes a good deal of uncertainty in the future for Mexican politics.

The nationalist social democrat Rodrigo Borja was elected president of Ecuador in May 1988, promising to reverse the free market approach taken by his predecessor, Leon Febres Cordero, and to raise wages substantially at the same time. Borja barely defeated a far more radical candidate, Abdalar Bucarem, who took a much more confrontational and anti-free market stance. Carlos Andrés Pérez, president of Venezuela in the 1970s when the country was enjoying newfound wealth from its oil revenues, was returned to office in December 1988. Pérez promised to restore prosperity but offered few specifics during the campaign. A post-election economic package, which consolidated the two-tier exchange rate and loosened price and interest rate controls, indicated a liberalizing trend. Yet accompanying wage increases and projected welfare expenditures immediately raised fears of inflation, highlighting the difficulty of implementing structural reforms without substantial social costs.

Latin politicians are frustrated by the formidable constraints under which they must operate and are aware of their weak connections to their societies. They also know that calls for austerity and structural economic reform do not have much appeal for populaces weary of deteriorating living standards. Attempting to win the support of these marginalized masses in the face of stark economic forecasts, leaders are sounding more radical and dogmatic. The checkered record of attempts to return to free market policies after periods of extensive state intervention — such as Febres' in Ecuador and former president Fernando Belaúnde's in Peru — lends support to more radical positions. Many politicians still cling to solutions stressing increased state control of the economy despite the proven limitations of their public sectors. The dearth of innovative and more realistic programs augers a future of continued economic deterioration and possible political upheaval for Latin America.

U.S. Interests

Political and economic instability in Latin America has already had visible effects on the United States. U.S. efforts to undermine the Sandinista regime in Nicaragua by aiding the contra rebels have divided our own government

and increased tensions with other Latin nations. The hundreds of thousands of people of Central American and Caribbean origin who come into the United States, legally and illegally, to search for employment or escape political repression have severely strained federal, state, and local resources and heightened racial tensions. The devastation caused by the drug traffic hardly needs recounting; few Latin issues have received more attention.

On the trade front, U.S. manufacturers lost an estimated \$18 billion in potential exports to Latin America from 1981 to 1983 alone. Loss of Latin markets is estimated to have cost the United States at least half a million jobs, not to mention its negative effect on the trade deficit. The \$395 billion Latin nations owe to U.S. banks makes our financial system particularly vulnerable to economic or political upheaval in the region.

In the longer run, the viability of the U.S. economy is inescapably linked to the world economy; America no longer occupies the position of dominance it once did. A successful Latin America will be fundamental to world economic growth and thus to our own. Continued stagnation will not only retard world growth but contribute to a widening split between the industrialized economies and the newly industrializing Asian economies on the one hand and "basket-case" third and fourth world economies on the other. No other power has closer ties to, greater interest in, and more influence with Latin America than the United States. Recognition of our interests and responsibilities in the region will be critical to Latin economies and governments in the short term and to our own in the longer term.

Yet American policy toward Latin America has been defined rather narrowly, and primarily from a military perspective. By conventional military criteria, U.S. interests in the region are few. Cuba's pro-Soviet stance and its penchant for playing the troublemaker is clearly a concern, as is the hostile regime in Nicaragua. The Soviets, however, have demonstrated their unwillingness to invest the political and economic capital necessary to support another Cuba. Nicaragua, a nation virtually devastated by civil war and economic mismanagement — inflation exceeded 20,000 percent in 1988 — hardly poses a credible military threat to the United States.

If U.S. security is defined more broadly to incorporate issues such as nuclear proliferation, terrorism, drug trafficking, and immigration, then Latin cooperation will be necessary to solve these problems. U.S. interests are directly linked to the success of friendly, stable, and preferably democratic regimes in Latin America. Our dilemmas with the unfriendly regime in Panama are a case in point.

If the U.S. perception of security threats in Central America has been exaggerated, its response to Latin America's debt crisis has clearly been inadequate. The Baker Plan was too little, too late, and left most of the initiative — which did not occur — up to the private banks. Debt relief plans for Latin nations in the 1930s and 1940s were more generous and innovative — even after most countries had defaulted — than those in place today. The

Peru: A Warning Signal?

Peru can claim all of the major problems facing Latin America, most of them in extreme form. The events of a recent day in Lima are telling.

On November 22, 1988, the economics minister was scheduled to announce drastic austerity measures that would raise the price of most basic goods by as much as 150 percent. These measures were a belated attempt to keep reserves, already \$300 million in the red, from dropping further, cut a burgeoning fiscal debt, and curb an inflation rate spiraling to well over 1,000 percent. Growth for the year was expected to be negative 10 percent, a dangerous situation for a nation that had suffered a 50 percent deterioration in its real wage levels in the past decade and where 40 percent of the work force was either underemployed or jobless.

The minister's address could not be televised, however, because the Shining Path guerrilla movement had blown up 10 electricity pylons, black-

ing out the capital and much of the country's north coast. The same day, Tupac Amaru, the milder of the nation's two main guerrilla groups, had exploded two mortars in the headquarters of the antiterrorist police agency, Dircote. Peru ranks second only to El Salvador in Latin America in numbers of deaths from political violence and in 1986 recorded the third highest number of terrorist incidents in the world. Fighting between the military and the brutal, Khmer Rouge-style Shining Path has claimed 15,000 lives since the guerrilla group began armed activity in 1980.

Higher prices, a power outage, and terrorist actions were not the only problems on November 22. Lima's water reserves fell so low that the water — for the third or so of Lima's population that has access to running water — was contaminated with methane and nitrate gases. Like most days, strikes and demonstrations were rampant; this Tuesday copper miners, textile and transport workers, and Ministry of

Public Works employees were all on strike. Queues of up to four hours or more for oil, flour, rice, and other basic foods were the norm.

President Alan García, meanwhile, remained in seclusion in his palace — at one point he had not appeared in public for 33 days — trying to dissociate himself from an economic crisis largely of his own making. Day-to-day life in Peru has become one of economic chaos and unrestrained violence.

Great Expectations

High hopes both within and outside Peru greeted the election in 1985 of Alan García and his center-left American Popular Revolutionary Alliance party. Since returning to civilian rule in 1980, Peru had been beset with deep recession and deteriorating living standards. A \$9 billion debt inherited from the military constrained the economy, and the emergence of the Shining Path movement challenged the government's ability to maintain

earlier plans included reduction of interest payments and capitalization of interest. Today the private banks have yielded only by rescheduling amortization payments and by reducing the interest spreads over market rates, while the World Bank and the International Monetary Fund have not provided the guidance that some might have expected. U.S. and Latin experts have put forth a host of debt reduction schemes, ranging from interest reduction and capitalization schemes resembling those of the 1930s to a number of interesting but limited plans for debt-equity swaps. U.S. policymakers have yet to move beyond the Baker Plan, although the Bush administration promises to take a new look at the debt problem.

Shared Responsibilities

It is much easier to identify our interests in the region than to identify solutions for the crisis it faces. The continent's problems cannot be blamed on the United States. Neither, however, can the United States abdicate its responsibility for helping to solve them. To that end, U.S. leaders must treat more seriously than they have in the past requests from Latin leaders for debt relief, for trade reciprocity, for

comprehensive attention to the problems facing the region. We should hardly be surprised at Latin skepticism when we insist on protecting our textile, footwear, and agricultural industries from Latin exports while aggressively promoting open markets and free trade in the developing world. Latin leaders, too, will have to change their attitudes. Desperation and frustration make it easier to blame problems on powerful external forces than to accept a share of the responsibility.

Stopping the drug trade will continue to occupy considerable resources both here and in Latin America. The United States should broaden its focus beyond crop eradication and border patrols. As long as there is continued demand for drugs in this country and an absence of viable economic alternatives in the producing countries, a solution to the drug crisis is difficult to envision.

The United States should also review its foreign aid package, which has not been comprehensively reassessed since 1973. While economic and military assistance to Egypt and Israel is projected at \$5.3 billion for 1989, the figure for Latin America is \$1.1 billion; \$902 million of that is concentrated in Central America. U.S. foreign aid is not the solution to Latin America's problems, nor can the

order. Despite falling prices for its commodity exports and a disastrous cycle of floods and droughts at home, Peru got little sympathy from the international financial community. With no new foreign capital headed in its direction, Peru had little incentive to pay its debt.

Charismatic, autocratic, nationalistic, and extremely popular among the poor, Garcia had all the traits of the populist. Once elected he immediately challenged the international financial community, declaring that Peru would pay no more than 10 percent of its export earnings to service its debt. He also implemented a "heterodox" economic strategy, which, like its counterparts in Brazil and Argentina, was based primarily on reactivating domestic production by boosting internal demand.

García's bold approach was initially successful; the economy grew 8 percent in 1986, another 7 percent in 1987. Even the conservative private sector supported him, in part because the alternatives to the left were far more radical and in part because his predecessor's export-led strategy had been a disaster. During his first two years in

office, García's approval rating ran above 75 percent.

The Turning Point

By mid-1987, however, García's short-term reactivation strategy had run its course, and the need for economic adjustment was clear. García opted instead to nationalize Peru's banks, something he had promised never to do. García apparently hoped the expropriation would shore up his support with the poor and the left, but his gamble failed because neither group had anything to gain from the nationalization. The move did, however, spur Peruvian novelist Mario Vargas Llosa to enter politics. He launched an independent movement, backed by the entrepreneurial classes, to protest the bank nationalization.

García's behavior grew increasingly authoritarian and confrontational. He ordered army tanks to break down bank doors in defiance of a court injunction to stop the bank takeover, and he subsequently called for a war economy, declaring immoral anyone who owned a car or an electric blender.

The president's insistence on water-

ing down difficult economic adjustment measures — and his continued refusal to negotiate with Peru's international creditors — has devastated the economy and helped to polarize the political system. By the end of 1988, García's approval rating had fallen to about 15 percent. Even Alfonso Barrantes, the leader of the Marxist left, stated that Peru had to obtain external credit "before the roof falls in."

The two likely candidates for the 1990 elections — if they are held — are Vargas Llosa, backed by the remnants of the old Peruvian right with which he is formally allied, and Barrantes, a crafty politician who is the de facto head of the United Left, the main opposition coalition in Congress. Members of the United Left range from moderate socialists to Trotskyites and Maoists who actively support armed insurrection.

In this context, the fact that elections were held in 1985 and are scheduled in 1990 has limited significance. The current crisis has exposed the fundamental lack of cultural, economic, and political integration in Peru, a breach that formal democratic institutions alone cannot close.

constraints of the budget deficit be ignored. Yet given the extent to which the debt crisis has affected the development potential of an entire generation of Latin Americans and our own stake in the region, it makes sense to evaluate whether we are using our limited aid effectively.

At bottom, economic progress is the prerequisite to solving Latin America's problems. It will entail changes in development strategies, difficult adjustments in inefficient public sectors, and the adoption of production strategies that can provide jobs and incomes for the marginalized.

Some lessons can be learned from the Chilean experience; the curbing of fiscal deficits, the maintenance of a realistic exchange rate, and privatization of inefficient state enterprises all contributed to successful growth there, albeit after an extremely difficult adjustment period. Unlike the Pinochet regime, however, neighboring elected governments must also respond to popular demands, and internal reforms will not be politically palatable, without new flows of foreign capital and prospects for growth.

No new capital is in sight, however, and none of any significance is likely to be until the debt crisis is resolved. That will require a cooperative effort that goes far beyond current bilateral and multilateral aid and credit relations. It

is in this area that U.S. leadership is essential. As the failure of the Baker Plan proved, no major debt relief initiatives are likely to come from the private sector until the U.S. government adopts a comprehensive approach — entailing at a minimum the discussion of the debt issue in regional terms, rather than on a case-by-case basis, and the acceptance of some responsibility for solving the crisis. Only with a solution to the debt crisis in hand can the region undertake the difficult adjustment required for future growth — and ultimately political stability.

Beyond the debt crisis, the severity of the region's problems dictates a new conceptualization of age-old development issues on the part of both Latin and U.S. policymakers. Genuine democracy in the region will require the provision of opportunities so that cultures are not split into haves and have-nots, formal and informal economies, societies and states. Until that occurs, no consensus on democracy versus dictatorship, capitalism versus Marxism, civilian versus military government will be a lasting one, and a fundamental gap will persist between the formal political, economic, and legal institutions in Latin America and the societies they purport to represent.

The Problem of Governance

Can the Government Govern?

Edited by John E. Chubb
and Paul E. Peterson
\$10.95 paper; \$29.95 cloth



"The true test of a good government," Alexander Hamilton wrote, "is its aptitude and tendency to produce a good administration." By that measure, American political institutions in recent years have fallen short. Indeed, the management of some crucial contemporary problems has been disappointing for so many years that John E. Chubb and Paul E. Peterson have been prompted to ask: Can the government govern?

This book emphasizes how much we have yet to learn about making our governmental institutions more effective. In the three perhaps most troubling and important policy areas of the late 20th century — energy, trade, and finance — the divisions of responsibility among Congress, the presidency, and bureaucratic agencies seem to work less well than we have a right to expect. What is more, if divided government becomes a permanent political reality, with Democrats controlling Congress and Republicans holding the White House, as seems to be the case, institutional conflict could well become even more entrenched.

Chubb, a senior fellow in the Brookings Government Studies program, and Peterson, professor of government at Harvard University, maintain that the dilemma is not partisan in nature but "inherently and substantially institutional." Although the authors discuss a variety of policy and institutional reforms, their purpose is to explicate the causes and consequences of institutional intransigence. "When governments of quite different political combinations all fail to perform effectively, it is worth considering whether the problem is the government itself and not the people or parties that run it," they write.

Contributors include Samuel Kernell on the presidency, Kenneth A. Shepsle on Congress, Terry M. Moe on the bureaucracy, Chubb on energy policy, David B. Yoffie on trade policy, and Peterson and Mark Rom on macroeconomic policy.

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